CAPITAL GAINS TAX REFORM AND INVESTMENT IN SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, JANUARY 26, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–7

U.S. GOVERNMENT PRINTING OFFICE

87–713 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047329-2

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CAPITAL GAINS TAX REFORM AND INVESTMENT IN SMALL BUSINESS

THURSDAY, JANUARY 26, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room 2359–A, Rayburn House Office Building, Hon. Jan Meyers (chairwoman of the committee) presiding.

Chairwoman MEYERS. Ladies and gentlemen, the committee will come to order. This morning the committee will continue its examination of the Contract With America, focusing on the capital gains tax reduction. This provision provides a 50 percent, across-the-board reduction in the capital gains tax, and indexes the value of the asset for inflation, to prevent the tax from being levied on illusory gains.

I think you are all aware, of course, that the committee on Ways and Means has jurisdiction over tax issues. We have told the Chairman of the committee and the Ranking Member that we would be happy to work with them in any way we can to bring a particularly small business perspective to the importance of all of the tax issues. We will convey to the Ways and Means Committee as well as use testimony or reductions for our own edification.

I strongly support this provision in the contract as a way to encourage investment in small business and as a step toward eliminating the Federal tax policies we have in place that penalize savings and investment for the future.

Jerry Heaster, a columnist for the Kansas City Star, who brings a great deal of common sense to the issues, wrote a piece for the January 15, 1995 edition of the Star, which discussed this very issue.

Currently, persons who spend every after-tax dime in their pocket are wiser from a tax standpoint than those who put some of their after-tax dollars into savings and investment because the earnings on any savings and investment are taxed again. That was the point of view of Mr. Heaster as he went on to develop the idea.

We provide few advantages through the Tax Code for people who save for their future or invest in companies that could improve the future of many through new employment opportunities or new products and services needed in our society. The witnesses with us today have varying points of view on the issue of capital gains taxes, but all agree that there should be some reduction or elimination of capital gains.

Some favor an across-the-board reduction policy. Others offer a more targeted approach. However, I think it is important to point out this widespread recognition of the need to reduce capital gains taxes. As those with us will point out with the authority of statistics, capital gains taxes are not a matter of concern just of the rich. Approximately 75 percent of all capital gains taxes are paid by those with incomes of less than $75,000. Over half of all taxpayers with capital gains in 1992 had incomes of less than $50,000. The capital gains tax affects countless Americans, directly and indirectly, and it is time we reduced its anti-investment impact.

At this time I would like to recognize Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Madam Chairman. Our committee's examination this morning of tax provisions in H.R. 9, the Job Creation and Wage Enhancement Act, will focus on proposals for a 50 percent exclusion on capital gains and a neutral cost recovery system that will increase the value of investment depreciation.

Without going into details regarding the way this will be accomplished, I am troubled by the impact this will have on Federal revenues as well as the broad-brush approach taken as a means to encourage investment.

First, according to estimates by the Treasury Department, the proposed capital gains tax cut will cause a revenue loss of $61 billion in the first 5 years and $183 billion between 1995 and 2005. Treasury reports that the neutral cost recovery system will cost $120 billion in lost revenues over the next 10 years.

This revenue loss will create extreme pressures on an already untenable budget deficit. If we should pass a balanced budget amendment, the prospects for program cuts and greater economic hardship on working Americans is enormous. I believe it is difficult to justify giving generous tax breaks to corporations and wealthy individuals at a time of fiscal austerity when we may be forced to cut certain Government benefits and otherwise impose enormous burdens on average citizens.

Second, these tax cut proposals provide across-the-board tax reductions in the generalized hope of creating more savings, more investment and more jobs, without any assurance we will achieve specific policy goals. But studies by Treasury, the Congressional Budget Office, and Congressional Research Service have concluded that capital gains tax cuts have very small effects on savings, very small effects on investments and very small effects on economic growth.

Relying on such tax cuts to stimulate sufficient growth to ensure the creation of well-paying jobs is far too amorphous and uncertain an approach, heightening expectations that cannot be met. When adopting fiscal measures to encourage investment, I personally believe we should take a targeted approach.

We know, of course, that all investment is not created equal. We must decide if we want to encourage investment in, for example, high-technology industries, as opposed to real estate development. We may want to encourage long-term holding of capital investment. We certainly want to focus on investment that enhances productivity and creates good paying jobs. We should shape our tax policy to meet our investment objectives, objectives that meet the goals of

society as a whole, not just a small and already wealthy segment of it.

Chairwoman MEYERS. Thank you, Mr. LaFalce. We will proceed with hearing from our witnesses.

Our first witness this morning is Dr. John C. Goodman, president and CEO of the National Center for Policy Analysis. He has a Ph.D. in economics from Columbia University and is the author of seven books and numerous articles published in professional journals. Dr. Goodman.

TESTIMONY OF JOHN GOODMAN, PRESIDENT AND CEO, NATIONAL CENTER FOR POLICY ANALYSIS, DALLAS TEXAS

Dr. GOODMAN. Thank you Madam Chair and members of the committee. The 1996 Tax Reform Act increased the maximum tax rate on capital gains from 20 percent to 28 percent. This 40 percent tax hike has reduced Government revenues, discouraged entrepreneurship, and caused many investors to hold on to assets they would prefer to sell. It has harmed the economy in general. By contrast, the proposal in the Contract With America to cut the capital gains tax rate in half and to index capital gains would, if enacted into law, benefit both taxpayers and the Government.

Now, the case for indexing is straightforward. The tax brackets are currently indexed so people who receive only wage income cannot be pushed into a higher bracket by the effects of inflation alone, but there is no such protection for people who receive capital income. As a consequence, investors are paying taxes on inflationary gains. This is unfair and damaging to the economy as a whole.

The case for a lower rate on capital gains is less well understood. Many argue that this would be a special tax break for people who receive one kind of investment income over other kinds of investment income. But nothing could be further from the truth. A capital gains tax is not really a tax on income. It is a tax on asset transfers.

If there were no capital gains tax at all it would still be the case that all of the income generated by these assets would be taxed. Bonds generate interest income. Stocks generate dividend and retained earnings income. All of this income would be taxed.

Furthermore, in the absence of any capital gains tax, the owners of assets would indirectly pay this tax on income because their assets would be worthless. With a 28 percent tax on investment income, every asset is worth 28 percent less. This is why in most other countries in the world there is no capital gains tax at all; or if gains are taxed, they are taxed at a much lower rate.

Now, some have argued that the capital gains tax cut that we are considering would cause the Government to lose revenue and as Representative LaFalce just said, the congressional forecasting agencies and the Treasury are predicting that. But all three of these agencies have been wrong in the past in their predictions about capital gains tax revenues and if you consider this chart over here to your right, you can see why they have been wrong. What happened before the 1986 tax increase is that there was massive selling to get assets sold before the rate hike went into effect and since that time——

Mr. LAFALCE. I wonder if I might interrupt for just 2 seconds to say, Madam Chair, I would hope that at some point in time in order to bring balance to the hearing we could have the CBO, the Congressional Research Service, all those agencies that this gentleman has taken issue with, testify on this issue.

Chairwoman MEYERS. I am sure that we will. I would like to mention that Mr. LaFalce did submit some names. We would like to contact them. They were unable to be here today. I am sure that as the year goes on we are going to have some further hearings. Thank you, Mr. LaFalce. Excuse me.

Dr. GOODMAN. All three of these agencies predicted that as a result of the 40 percent rate hike, there would continue to be an ever-increasing capital gains realizations and the Government would get increased revenues.

They were all wrong, as you can see from that chart. Capital gains income as a percent of national income is lower today than it was in the 1970's and it is hard to escape the conclusion that investors are simply responding to tax rates imposed upon them by Government.

I would suggest if we cut the capital gains tax rate in half and you wanted to know what was going to happen, a good prediction would be to take that chart and turn it on its head—investors would respond to a tax cut in a precisely opposite way that they have responded to a tax increase.

Now, what would be the effect on the economy of cutting the capital gains tax rate and indexing. One effect would be more investment. Numerous studies show that investors are highly sensitive to tax rates on investment. The mistake made by the CBO and JCT and those another agencies that Congressman LaFalce referred to, is they are looking only at the behavior of the savings and they are failing to consider the international capital flows that respond almost immediately to changes in tax rates on investment income in the United States.

Our own forecasters who have been quite accurate in their predictions of effects in changes in taxes on investment income, predict that if we enacted this provision of the Contract With America we would create 721,000 new jobs by the year 2000 and cumulatively increase the gross national product by the year 2000 by $1 trillion.

Now, the final question is: Is this fair? In answering that question, the usual assumption is that this is a static change and only benefits people who realize the capital gains. Nothing, again, could be further from the truth.

The lowering of the capital gains tax rate makes investment more attractive. As investment becomes more attractive, you get more investment funds in the U.S. economy. Roughly, for every $1 after tax an investor takes home, wage earners take home $12, so 90 percent of the gain from the capital gains tax would be realized by wage earners in higher wages because of new investment that would be generated by this stimulus to investment.

I did not as part of my testimony present evidence on the Neutral Cost Recovery Act, but I would be happy to testify on that as well. Thank you, Madam Chairman.

[Dr. Goodman's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you, Dr. Goodman.

Our next witness is Mr. Pete Linsert. He is the chairman and CEO of Martek Biosciences Corp., employing 58 scientists including eight Ph.D.s. He is a member of the Biotechnology Industry Organization.

TESTIMONY OF PETE LINSERT, MARTEK BIOSCIENCES CORP., BIOTECHNOLOGY INDUSTRY ORGANIZATION, COLUMBIA, MARYLAND, ACCOMPANIED BY CHUCK LUDLAM, ESQ., VICE PRESIDENT FOR GOVERNMENT RELATIONS, BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. LINSERT. Thank you, Madam Chair. My name is Pete Linsert and I am chairman and chief executive officer of Martek Biosciences Corp. in nearby Columbia, Maryland. Today, I am testifying on behalf of the Biotechnology Industry Organization, which we call BIO, and BIO represents 570 biotechnology companies and others involved in every sector of the biotechnology industry including divisions such as biomedical, bioagricultural, bioremediation, and bioenzymes.

Accompanying me this morning is Chuck Ludlam on my right, BIO's vice president for Government affairs. Moreover, Chuck has served for 8 years as chief tax counsel for the Small Business Committee in the other body.

As all entrepreneurs must do, let me just start out with the bottom line and BIO supports the enactment of both an across-the-board capital gains incentive and a second tier incentive targeted at direct investments in the stock of emerging companies.

Let me provide some background on Martek and the biotechnology industry and on BIO's proposal for a two-tiered capital gains incentive. First Martek. Martek is 10 years old this year. We have raised over $25 million in equity capital and have obtained approximately $6 million from 40 small business innovation research grants and they are primarily from NIH and we started with five scientists back in 1985 and we now employ 70 people directly primarily in the life science disciplines and indirectly numerous others through subcontractors for clinical research, as well as suppliers of equipment and services.

Martek develops products for improved health and nutrition from microalgae, a separate kingdom of organisms in nature living in the world's oceans lakes, and rivers. These organisms provide vast resources utilized in biological development much like today's rain forests. They are biochemically different than other organisms, and thus are a great source of unusual compounds of potential value for humans.

We are just about to start marketing our first product. This product is based on unusual fatty acids microalgae make that strangely enough are found concentrated in the gray matter of human brains, the retina, heart, and nervous tissue throughout the body. Basically, wherever you find electrical activity in the body. Humans have a great deal of brain development after birth. This requires a dietary supplementation for these fatty acids for this brain development.

In the history of humans, these fatty acids have been provided in human breast milk, but they are not found in infant formula.

Over the last 5 years there has been an growing and increasing body of evidence that indicates the lack of these fatty acids in infant formula can lead to long-term IQ deficiencies and behavioral problems.

This not only applies to infants born normally on time, but also is true, especially for low birth weight and pre-term infants which make up approximately 250,000 children born in the United States alone each year. As a result of its lengthy R&D, Martek has developed patentable manufacturing technology that will provide these fatty acids in mass economic quantities to support infants and their mothers throughout the world.

The issue for entrepreneurs in biotechnology is capital formation--access to capital markets. This is what I spend more than half my time on at Martek. Bringing a biotechnology drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the FDA, the process can take 10 to 12 years, and thus costing anywhere from $150 to $360 million.

Both the length and the cost of this process are a tremendous impediment for small biotechnology companies to be successful in bringing a new product to market. So, after raising enormous amounts of capital to find cutting edge research, a company can find that its lead product is not approved by the FDA. We work in an industry which cannot sell or market its product without Government approval, and the requirements for approval are many times onerous.

The biotechnology industry consists of over 1,300 companies, of which 265 are publicly traded, and is one of the most capital intensive industries in the history of civilian manufacturing. R&D expenditures in 1994, last year, averaged $68,000 per employee in our industry. This compares to an expenditure of $7,500 for employee for all manufacturing companies.

The industry experienced a net loss of $4.1 billion in 1994 on this research and has lost approximately $14 billion over the last 5 years. Now, the industry, right as I speak, is in the middle of one of the worst financial crises in its history.

A major contributing factor on this crisis was the administration's assault on drug prices. The American Stock Exchange biotechnology stock index has declined by 50 percent since January 1993. So, we have really felt this in our stock prices and the value that the public puts on our industry.

BIO supports enactment of both an across-the-board capital gains incentive and a second-tier incentive targeted at direct investments in the stock of emerging companies. We support both because biotechnologies depend directly on equity investments to fund research. With so few products approved and so little in sales as compared to expenses, equity investments are the principal source for our funding.

Investors are asked to take tremendous risks with these investments and a risk that the firm's science will be successful, that the products will be approved for sale by the FDA, and the EPA, and that the market sales will produce profits commensurate with the risk, and this risk must be sustained over the 10- to 12-year period which is involved in biopharmaceutical drug development.

The two-tiered capital gains supported by BIO originated with Senator Robert Packwood. In 1989 he proposed a combined across-the-board capital gains tax cut and a target venture capital gains incentive. The Packwood capital gains proposal included a sliding scale capital gains tax reduction depending upon the length of time the capital asset has been held. It proposed that, "qualified venture capital stock" held for 4 or 5 years receives a gains tax reduction which was roughly twice as great as the incentive for the nonventure capital stock.

The definition of venture capital stock in his proposal was based on a targeted capital gains bill proposed by Senator Dale Bumpers and Congressman Bob Matsui. President Bush, Governor Clinton and Senator Gore all endorsed a targeted capital gains incentive during their 1992 campaign. The targeted capital gains proposal was also endorsed by the National Federation of Independent Businesses, National Venture Capital Association, and American Electronics Association.

The targeted incentive which Senator Packwood, President Bush and the Clinton-Gore campaign endorsed provided for a 50 percent reduction in capital gains taxes for direct investments in the stock of small businesses. The stock had to be purchased from the company and not in the secondary markets. It had to be held for at least 5 years. This is not short-term flipping of assets. This is patient, long-term money. A small business was defined as one with $100 million or less in aggregate capitalization.

The incentive applied to investments by individual and corporate taxpayers. Unfortunately, after their election, President Clinton and Vice President Gore proposed drastic limitations on the targeted capital gains incentive during the fiscal year 1994 budget debate, incentives which effectively gutted the incentive. I have included a list of six major limitations they proposed in my prepared testimony.

The incentive with the Clinton-Gore administration was included in the 1993 budget reconciliation bill and became law. An informal survey of our members at BIO found that this incentive has not been a factor in forming capital for our entrepreneurs and emerging companies.

Well, BIO is delighted that Congress is poised to finally enact an across-the-board capital gains tax reduction for capital investments and we support the capital gains provision in the Contract With America. BIO continues to support a targeted capital gains incentive which supplements this across-the-board incentive.

This second-tier more, powerful targeted incentive would ensure that there exists a distinct and more powerful incentive for high-risk, long-term investments in entrepreneurial and emerging companies. We believe there is a bipartisan consensus on the merits in favor of a targeted gains incentive.

The second-tier incentive would build on the false start of the 1993 incentive in eight ways outlined in my testimony.

The U.S. biotechnology industry is a major success story in the making. It is the most entrepreneurial in terms of research intensity and capital formation. It thrives on innovation and long-term risk taking. We as a society should ensure that our tax codes recognizes its unique characteristics and needs. Thank you very much

for the opportunity to testify today. I am happy to answer your questions at the appropriate time.

[Mr. Linsert's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you, Mr. Linsert. We are very glad to have you here today and thank you, Mr. Ludlam.

Our next witness is Ms. Sidney Hoff-Hay and she is on the board of directors of the Small Business Survival Committee. She serves as the Executive Director for several entities, including the Lincoln Caucus, and the Arizona Mining and Industry Get Our Support, or the AMIGOS trade association.

TESTIMONY OF SYDNEY HOFF-HAY, PRESIDENT AND EXECUTIVE DIRECTOR, THE LINCOLN CAUCUS, PHOENIX, ARIZONA

Ms. HOFF-HAY. Thank you, Chairman Meyers, members of the committee. I would like to thank the Small Business Committee for the opportunity to testify on behalf of the Small Business Survival Committee's 40,000 members. The Small Business Survival Committee is a nonprofit, nonpartisan advocacy organization fighting for our Nation's small businesses.

My name is Sydney Hoff-Hay and I am a board member of the Small Business Survival Committee. I also serve as executive director of AMIGOS, a trade association in my home State of Arizona, an association of small businesses that are suppliers to industry.

Through AMIGOS, I am in contact daily with small business owners. It is indeed a pleasure to be before you today to discuss how the Federal Government and the administration can further unleash America's true entrepreneurial capacity and help to encourage and sustain long-term economic growth. If there is anything in America that represents attainment of the American dream, it is owning your own business. But the greatest single obstacle to owning and running a business is Government.

Recently, a long-time business leader in Phoenix shut down his business. He just closed his doors; the doors to a business that had employed over 100 people. Why did he do it? Well, he was just tired of the battle. He was tired of fighting Government at every level. Each new piece of paperwork, each new regulation, new tax, new fee. Well, finally he had just had enough and it wasn't worth it anymore. I called him when I was asked to speak here today to ask him his opinion on the capital gains tax cut.

He said, I am holding on to those assets, the building, et cetera, of that business. He said because I refuse to pay taxes on a loss. That is the result of the fact of the nonindexing. His building has somewhat kept up with inflation and that is all. He absolutely refuses to sell that asset because he will not pay tax on an illusory gain.

This is a real-life example that I believe demonstrates to me exactly why the forecast of capital gains tax revenues have consistently run below Government expectations because higher rates have led to lower revenues. Ever since the 1986 increase, Americans have simply held on to their stocks, assets, et cetera. Now, this Contract With America provision which lowers and indexes capital gains tax is a good start to begin unleashing what I firmly believe will be a torrent of economic activity.

Another Arizonian I know on the other end of the spectrum is just starting a new business. He has come up with a state-of-the-art new product. He has found a market for it and he is just beginning the manufacture of it. I called him when I was going to testify here today and he told me that the current capital gains tax rate has been a huge impediment toward his being able to finance his part of the American dream.

He said, America is supposed to stand for capitalism, but the rest of the world seems to be a whole lot ahead of us in that regard. Our own Government seems to discourage it. Venture capital, whether it is from one's own family and friends or from professional investors, it remains a critical source of funding to new businesses and the current nonindexed Federal tax rate of 28 percent on capital gains remains a formidable obstacle to venture capital and to economic expansion. It is a direct tax on wealth creation and because of that, we get less wealth creation.

Investments in entrepreneurial ventures carries significant risks and high risks ventures must at least present the opportunity for rewards. The United States Tax Code, especially in its treatment of capital gains, should not stand in the way of investment and risk taking of economic growth.

While the Small Business Survival Committee fully supports eliminating the capital gains tax, the contract for America proposal which combined with indexation reduces the top rate to 19.8 percent could be the most pro growth, pro American dream step taken by the new Congress.

I want to thank you again for the opportunity to testify today. The Small Business Survival Committee certainly looks forward to working with each and every one of you in the days ahead. I certainly look forward to your questions.

[Ms. Hoff-Hay's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much for being with us, Ms. Hoff-Hay.

Mr. Paul Pryde is president of Pryde and Company where he consults small and minority firms on financial issues as well as the National Center for Neighborhood Enterprises. Welcome, Mr. Pryde.

TESTIMONY OF PAUL PRYDE, PRYDE AND COMPANY, WASHINGTON, DC

Mr. PRYDE. Thank you, Madam Chairman. I am delighted to appear before you today to express my views on the role of Government policy, tax policy in particular in encouraging investment in small businesses.

Chairwoman MEYERS. Mr. Pryde, I wonder if you could speak—maybe that would bend down a little bit and you could speak fairly directly into it because the people in the audience sometimes have trouble hearing.

Mr. PRYDE. Thank you. The important role played by small young firms in generating new jobs in this economy has been widely documented. What may not be as well known, however, is the critical contribution made by minority firms in particular in creating jobs for African-Americans and Hispanic citizens.

In his recent book, Banking and Black Business, Timothy Bates, perhaps the Nation's leading authority on minority entrepreneurship, found that firms owned by members of minority groups have a greater propensity to hire minority workers than similar white firms.

Bates' findings in this regard makes one conclusion inescapable. If one wants to reduce rates of Hispanic or minority joblessness, or African-American joblessness, increasing the formation and growth rate of firms owned by minority entrepreneurs has to be a part of the strategy. In addition to discovering the previously unresearched link between minority employment and minority entrepreneurship, Bates found, as others have before him, that persistent capital access problems continue to inhibit the formation and expansion of the types of firms most responsible for job creation.

One result, of course, is that the Nation's distressingly high levels of inner-city and minority unemployment are even higher than they otherwise would be.

However, in considering new tax or other legislation to encourage increased investment in small and minority firms, it is important to keep three, I think, current policy imperatives in mind.

First, we must minimize public costs. Today's climate demands that we spend or invest the public's money more wisely. Thus, any new policy should cost as little as possible in achieving the intended results.

Second, we need to target help precisely. I think it is generally agreed by most people who capital markets generally work fairly well. Therefore, it is important that policy changes be aimed in a rifle shot manner at the market problem to be solved. Failing to do this could cause market distortions worse than the original difficulty. The cure will be worse than the disease.

Finally, we need to market policy in a way that achieves economic equity. Well-considered changes in tax policy can greatly improve the efficiency of economy. However, it is important that more efficiency not be achieved at the cost of widened economic disparity. To put it bluntly, tax policy should not favor the haves over the have-nots.

With these standards in mind, I have some suggestions to make for making capital markets more efficient and fairer when it comes to small business. First, to overcome the problems that small and minority firms confront in securing private equity. The second two address the problems they experience in raising debt.

The first idea is we need to strengthen and refine Section 1044 and 1202 of the Internal Revenue Code. In 1993, after years of debate Congress enacted two capital gains tax provisions aimed at helping small and minority firms. Section 1044 of the capital gains roll-over provision allows any corporate or individual taxpayer who sells stock in a publicly traded company to avoid capital gains tax by investing the proceeds in a specialized small business investment company. As you know well, an SSBIC is an SBA-regulated venture capital company organized for the express purpose of advancing minority firms.

Section 1202, the capital gains exclusion provision, provides that a 50 percent of gain from the sale of newly issued small business stock is excludable from income tax provided the stock is held for

5 years. Only companies with less than $50 million in gross assets and earning most of the income from active sources; that is, other than interest royalties and the like are eligible. SSBIC's, however, are expressly excluded from this limitation. In other words, stock investment in them is eligible for 1202 treatment.

Both Sections 1044 and 1202 are targeted to what members of both parties apparently agreed was a persistent capital market problem, the inability of small, young firms to raise equity in private capital markets. Instead of cutting capital gains taxes across the board, a step that is likely to be both costly and perhaps market distorting, why not perfect these two provisions. Specifically, I suggest the following amendments.

One, Section 1044 now requires that the purchase of SSBIC stock be made within 60 days after the date that assets eligible for 1044 treatment are sold. This is an unreasonably short interval and should be lengthened to at least 180 days.

Second, Section 1044 also imposes annual and cumulative limitations on the roll-over provision. This should be limited to taxpayers subject only to cumulative limitations.

Finally, Section 1202 expressly exempts SSBIC's from the requirements that issuers of eligible stock use most of their assets to engage in active rather than passive activities. However, the exemption does not apply to certain regulated investment companies and partnerships even though they may be organized for and engage in precisely the same activities as SSBIC's.

The SSBIC exemption available under Section 1202 should thus be made available to all investment companies organized for the purpose of investing in eligible firms. Substance, in other words, should prevail over form.

My second recommendation is that equity investment in eligible empowerment zone or enterprise community firms be made fully tax deductible. Many firms receive their early seed capital from informal sources, friends, family members and business associates. One way to encourage individual business investors—individual investors to provide risk capital to promising young firms would be to make equity investments in these firms fully tax deductible.

To reduce the costs and possible abuse of this provision, it could be limited to businesses located in designated empowerment zones and enterprise communities. Upon sale of the asset, the taxpayer would be taxed not at the normal capital gains rate.

I should point out that this provision was included in many early enterprise zone bills and deserves a trial under the current program. It should be paid for by reducing the value of the employee wage credits, which most economists find generally not very useful, available to empowerment zone firms.

Beyond difficulties in raising equity, a lot of small firms have difficulty securing debt. I have what I consider relatively low cost suggestions for increasing the availability of credit to small and minority firms. One, we could restore the tax exempt treatment to small issue IDB's.

The 1986 Tax Act restricted the issuance of tax-exempt debt to manufacturing firms. Restoring the ability to issue tax-exempt debt to other firms would increase the availability of affordable debt to an increased number of minority and small firms.

Second, we have been doing a significant amount of work on the creation of secondary markets for small business loans reasoning that the creation of such a market would increase the availability of credit to some businesses. We should think about allowing Fannie Mae and Freddie Mac which is now only permitted to hold housing assets to hold a small percentage of their assets in the form of commercial and industrial loans.

Limiting those purchases to a small percentage of assets should not distort the Agency's fundamental mission. I would imagine a lot of people in the housing industry would object to this notion, so at the very least, Fannie Mae and Freddie Mac should be asked to examine the impact of this proposed shift on the availability of both mortgage and small business credit.

Madam Chairman, finding ways to make capital markets work for small business is vital to America's social health and to its economic vitality. However, we don't need to invent entirely new ideas. Many of the policies and mechanisms required to increase the flow of private debt and equity in small firms are already in place or have previously been agreed on. By building on existing policy and past consensus, we can solve the capital access problems of these firms with a minimum of public cost and debate. Thank you.

[Mr. Pryde's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Pryde. You have given us a lot of ideas in very rapid fire ways.

Mr. Alan Sklar is a CPA from Chicago, Illinois. He will be representing Illinois small businesses as a delegate to the White House Conference on Small Business next June. We are glad to have you here Mr. Sklar.

TESTIMONY OF ALAN SKLAR, CPA, GLEESON, SKLAR, SAWYERS AND CUMPATA, LLP

Mr. SKLAR. Thank you, Madam Chairman and members of the committee and thank you for inviting me to testify today.

My name is Alan Sklar. I'm representing myself and other business owners. I am managing partner of Gleeson, Sklar, Sawyers & Cumpata, LLP. We are a 65-person CPA firm with two offices in the Chicago land area. We represent exclusively held businesses.

Therefore, I come before you as a business owner and an entrepreneur with responsibility for maintaining and growing a business and responsibility for 65 families. I am also a delegate to the White House Conference on Small Business in 1995 and I was a delegate to the White House Conference on Small Business in 1986.

I am chair of the Illinois delegation's Capital Formation Committee and a member of the Taxation Committee. I am also president of Small Business United of Illinois, a 200-plus-member organization representing interests of small businesses in Illinois.

So I come before you representing other small businesses, my small business, and seeing the impact of tax law on clients of our firm. What we are talking about here are more low-tech type of businesses than high-tech businesses.

H.R. 9 proposes cutting the individual capital gains rate to a maximum of 19.8 percent and indexing future gains against inflation so that you would only pay tax on your real gains. My experi-

ence in the past when capital gains were lowered was that many of our clients did sell their investments that they were holding on to and they were holding on to them because of high capital gains rates. So, when they did sell, it in effect, freed up money from frozen assets and made it available for other types of investments. I hope with proper incentives some of this money will go into small businesses.

Capital gains are also a form of double taxation because the corporation's profits have already been taxed. By lowering the rate on capital gains, that at least cuts down the impact of this double taxation.

But the biggest reason I am in favor of reducing the capital gains rate is that I do hope that it will serve as an incentive for people to invest in small businesses. One of the biggest needs for small business is capital, access to capital. Most small businesses in my experience are undercapitalized.

I believe by cutting the capital gains rate many more people will be willing to invest in small businesses. But, and there is always a but, when we are dealing with Congress, if this provision isn't passed, then I favor the expansion of the more targeted capital gains reduction that was passed in 1993, Section 1202.

Section 1202 says that if a person makes an investment in a qualified small business and holds the stock for more than 5 years, they are eligible to exclude 50 percent of the gain. A qualified small business, among other definitions, is one that is organized as a C corporation. This provision has limited tax impact for investments in small businesses because many small businesses are organized as S corporations. Investments in S corporations are not eligible for this 50 percent exclusion.

I believe it would be very beneficial as an incentive for investment in small business to expand the definition of a qualified small business to include S corporations. By including S corporations, many minority-owned, women-owned and other small businesses would qualify for this exclusion.

I believe cutting capital gains rates is a cost-effective way to spur investment and economic growth, but I don't think it is enough. We need to be more creative to create incentives.

I recommend proposed legislation that would utilize the Tax Code as an incentive for investments in small business, which I believe would encourage growth.

As I stated earlier, one of the most pressing problems confronting small business today is to raise capital for operations and expansion. Many minority women-owned and other small businesses are undercapitalized. This lack of access to capital also impacts their ability to borrow from banks.

The present Section 1244 of the Internal Revenue Code provides that an individual can take an ordinary tax deduction of up to $100,000 on a joint return or $50,000 on an individual return for stock purchased in a small business if that stock becomes worthless or sold as a loss.

Section 1244 was written to provide tax relief to an investor in a small business, presumably as an inducement to invest in the small business. Statistically, many small businesses do fail within

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5 years of formation, thus the provisions of Section 1244 are of great importance to a small business investor.

The major problem with Section 1244 is that it creates an illusory incentive for the investor in small business. The only way to get this incentive is to have that business fail and, to me, that is backwards.

What I am proposing is an investment as a Small Business Investment Incentive Act that corrects these illusory aspects of Section 1244 by offering an immediate, up-front, positive incentive. If it is assumed that the majority of small businesses failed, then the difference between this proposed act and Section 1244 is timing only, but on the other hand, if small businesses are successful and I think many of them are, then the investor receives all of his invested capital back. When the investor receives all of his invested capital back, the tax benefit will be paid back to the Treasury under the recapture provision of this act.

The Small Business Incentive Act is what I call it, over a period of time, will produce the exact effect of Section 1244, but it creates a stronger inducement to provide the needed capital for the small business community. It provides a tax deduction for investments in small business.

I propose that it would permit a qualified small business to raise up to $500,000 for operations and expansion through sale of its stock while allowing individual investors a deduction up to $25,000 on their tax returns, $50,000 on a joint return for stock purchased in a small business.

Qualified small businesses should include both C corporations and S corporations. In order to be sure that this provision is not abused and turn into a tax shelter, there should be no repayment for at least a 5-year period. The investor during this period cannot receive salary, interest, rent, dividends or any other type of payment from the small business during this 5-year period.

This will keep it from being utilized as a tax shelter and also will limit the investments in the business to new investors. I strongly believe that the impact of such a provision would be to create a strong incentive for individuals to invest in good small businesses. Nobody is going to invest in a small business just in order to get a tax deduction. They have to look at the economics of the situation.

Once a corporation does have more capital, more equity, it can then leverage this by going to a bank and obtaining financing. This provision will create a number of new jobs and, after all, it is the jobs that create the tax revenue and makes our economy grow. I believe that within a 3-year period this Incentive Act will provide net revenue and therefore will also act as a way of reducing the budget deficit. Small business is the economic engine that drives this country.

I ask you to recommend and support such a Small Business Incentive Act. I would just like to take about half a minute to make a pitch to correct a major income tax inequity for self-employed people.

Self-employed people include partnerships, self-employed and members of S corporations. In regular C corporations, payments of health insurance are deductible by the corporation and tax free to

the employees. But for self-employed people, again, this includes partnerships and S corporations, we don't get a deduction for these health care insurance premiums.

There was a provision up to 1994 through 1993 that allowed us to write off 25 percent of the health care premiums. So, I ask you to support a full 100 percent deduction so we are on a par with regular C corporations and if not then let's reinstate the 25 percent deduction that was taken away from us in 1994.

Thank you very much for this opportunity.

[Mr. Sklar's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you for your testimony and we did have a hearing on the 25 percent deduction, and we will add your comments to the other testimony that we received.

I think it has been my practice to recognize members of the committee in the order in which they arrived. I will do so. Because we have a lot of good people here to answer questions and quite a few to ask them, let me ask if you have a statement before your question, try to keep it brief enough so that we can have a question and an answer within the 5-minute period. Mr. Bartlett.

Mr. BARTLETT. Thank you very much, Madam Chairman, for convening this hearing and thank all of the witnesses. I come to this task from a business background and so I know whereof you speak.

Let me just comment very briefly on your request for consideration of the 25 percent deduction for health care insurance premiums. I agree with you that it should have been all along what industry gets. That is not probably 100 percent because industries don't pay 100 percent across the board, but it should be whatever it is in industry and I think all of us can agree with that.

It is my hope that we can get something targeted very quickly to just reinstate the 1994 so that all of the self-employed can file their income tax returns without concern that they are going to have to file an amendment. It is unfair enough to not give you the same kind of deduction that everybody else gets. It is doubly unfair to ask you to file an amended return to get back in 1994 what you have been getting back all along.

The scoring, as you all probably know, of tax cuts and tax increases is fairly mindless. If there is a tax cut, that decreases revenues and ordinarily no consideration is given to the stimulus of the economy which might, in fact, produce the reverse of that and I would like to ask with reference—and, of course, the reverse is also true.

I would like to ask in reference to the capital gains tax particularly, this is one tax where I think that that mindless approach does not do justice to what the effects will be on tax revenues. I am wondering if you all can give us specific evidence, historical evidence in the past or can give us assurances from past experience that a capital gains tax cut will so stimulate the economy that, in fact, one would not anticipate a decrease in tax revenues, but rather an increase in tax revenues.

Personally, I think the capital gains tax is one where this mindless approach is really not the proper way to evaluate what would happen. Can you help us with specific evidences in the back, from the past or prognostic indications for the future? Thank you.

Dr. GOODMAN. Yes, if I could have the mike.

All forecasting, Congressman, is a projection of the past and into the future. One of the simplest ways to do that is to simply look at the immediate past and that is what that chart to your right does. The Congressional Budget Office, the Joint Tax Committee and the Treasury all predicted that as a result of the 1986 tax increase, that the Government would get increased capital gains tax revenue. They projected a straight-line increase: As the economy grew, more revenue would come to Government. That is not what happened.

They were way off and with each passing year they have been more off. So, anyone who says that the capital gains tax cut is going to lose revenue for Government should bear the burden of proof, and if those agencies want to continue to maintain that position, then they should explain why their predictions were so wrong in the past. We predicted that the capital gains tax increase would lose revenue for Government. The chart is consistent with that. Capital gains income today as a percent of national income is lower than it was way back in the 1970's.

Chairwoman MEYERS. Thank you, Dr. Goodman.

Mr. Sklar did you want to speak to this?

Mr. SKLAR. My experiences are not as an economist, strictly but as a CPA that is preparing tax returns and giving tax advice to clients.

In the past and I have been practicing for over 30 years, I have seen that among our clients that it seemed like they were cashing in once the rates—when the rates were reduced. So I did see that impact. This is a very micro example and not macro.

When we are giving tax advice, we are always trying to get things into lower brackets and I see people rolling over their investments and not taking and cashing in their investments because of the high capital gains rate. People hold on to property, people hold on to their closely held corporations and they held on to the investments in their stock as long as possible because of high capital gains rate.

Chairwoman MEYERS. Mr. Pryde, did you have a comment.

Mr. PRYDE. Yes. Several years ago when we first proposed the notion of allowing investors in eligible companies to deduct their investments on an up-front basis, we decided to play "what if," what was likely to happen in terms of Federal tax revenues.

We said, well, let's assume we invest $100,000 in a set of 10 companies. That amount is deducted up front; that eight of the companies fail. The remaining two don't pay any taxes for 5 years and then they pay taxes on $100,000 in profits and those profits increase by 20 percent annually for 10 years.

Does the Federal Government gain or lose money just in terms of corporate income taxes? And we found that the rate of return was somewhere between 10 and 15 percent on that Federal Government investment. We found further that in order for the Federal Government to lose money from such a targeted incentive you would have to assume that increased capital worsened business formation rates and we considered that an absurd assumption, so pretty certain that over a 5- to 10-year period any investment in the form of foregoing revenues would be more than repaid by the

corporate income tax alone paid by companies that got increased access to capital.

Chairwoman MEYERS. Thank you. Ms. Hoff-Hay.

Ms. HOFF-HAY. In 1990 when the Congressional Budget Office predicted that in 1991 the revenues from the capital gains tax would be $269 billion, and they ended up being $108 billion, that is 150 percent forecasting error because it did not account for human behavior.

When the tax cut was changed in 1986, projections failed every single year. In fact, the revenues that resulted every year after 1986 fell below 1985 levels. But even if from a small business perspective, even if we accepted the static models, even if we said, OK, how are we going to pay for that, the fact of the matter, as far as the Small Business Survival Committee goes and small businesses across the country are willing to say Government is too big and, yes, we are all going to have to experience cuts of programs, but even if we accept that, which we don't believe is the case, that is what we are willing to accept is severe cuts in programs and all of that, but the fact of the matter is that we firmly believe that the opposite will be true.

You cut the capital gains, it will unlock what Americans have successfully avoided paying by holding on to their stocks or other assets to avoid paying the tax.

Chairwoman MEYERS. Thank you.

Mr. Linsert.

Mr. LINSERT. As I mentioned in the biotechnology business, we depend upon access to capital and we have generated a tremendous amount of research activity over the last 5 to 10 years and the industry relies on this access to capital. So, I know in my own company I spend over half my time dealing with investors, always looking to obtain more capital and so to our mind, the notion of reducing the barriers to invest for the long term is a way to generate dramatically increased activity in our particular industry. I know Mr. Ludlam might have some comments on some of the statistics.

Mr. LUDLAM. Congressman Bartlett, there are quite specific scoring on the targeted capital gains incentive which find that even in its most elaborate, most generous form and under the old static scoring system, it would lose no more than a billion dollars over 5 years.

For example, the scoring—this is under the old system of joint tax, a targeted incentive for $100 million of capitalization held for 5 years, with a zero percent rate on the first $5 million invested in it, in a seed capital investment, with a major expansion of the 1244 incentive, all of that was scored by joint tax under the old scoring system at $1 billion over 5 years.

Now, some of that incentive was enacted in 1993. The estimates in 1993 was that the targeted incentive in 1983 was $300 million, so if you take the rest of the target incentive which was not enacted in 1993, which included S corporations also, you have a relatively modest cost even under the old scoring system.

Mr. BARTLETT. Thank you. Your testimony confirms my personal conviction and that if we eliminated the capital gains tax that both the economy and the tax collector would be big winners. Thank you.

Chairwoman MEYERS. Thank you, Mr. Bartlett. Mr. Luther.

Mr. LUTHER. I have no questions.

Chairwoman MEYERS. Mr. Luther has no questions. Mr. Poshard.

Mr. POSHARD. Thank you, Madam Chairman. First of all, let me say that I support a modest capital gains tax reduction, but you know, through two different administrations now, we have had both Treasury and other folks advise us of the losses of eliminating the capital gains to the U.S. Treasury. That is under two different administrations, both Republican and Democrat. So, it is hard for me to believe that we are not going to lose some money to the Treasury if we completely eliminate the capital gains tax, because I am not sure that all that is going to be reinvested in the economy to stimulate it. I think it is a little unfair in the comparisons you are making between the capital gains realizations from 1985 before we had the 40 percent higher increase and the capital gains realizations that you cite in 1992.

The economy of the country in those 2 years was radically different. In 1985, we were at the very top of an economic recovery cycle. In 1992 we were going down and it is not quite accurate to compare those 2 years in citing your references. Although I do believe in general that not necessarily altogether eliminating, but certainly reducing the capital gains tax would be a positive step for us. And in terms of—I just think there is a fairness issue here, Madam Chairman, as much as anything else, and we can debate all day the effect on the economy and reinvestment and that sort of thing.

But I guess the question I would ask you, because I know we are going to get all wrapped up in this debate over depletion of moneys from the Treasury and trying to balance the budget and that sort of thing. If it came down to it, would you rather have a reduction in the capital gains tax rate or would you rather achieve indexing? If we had to face a choice between the two.

Dr. GOODMAN. In terms of the effect on the economy, I think they are about equal. Indexing is very, very powerful, but there is also a very large rate cut and so I would say they are about equal.

Mr. POSHARD. So either one you would accept and both if you could get it, right? But I mean you wouldn't choose one over the other as more important at this point in time for the small business community?

Dr. GOODMAN. Well, maybe some of the other witnesses have a preference. Just in terms of effect on investment and the economy, I think they are roughly about the same.

Mr. POSHARD. Anybody else want to express something?

Mr. SKLAR. Well, I think the reduction in capital gains is both short term and long term and I think the indexing is strictly long term. So, we are looking for some benefit today and we are looking for some benefit tomorrow in the economy. We do care about long term. That is critical, but if we can get some impact today, that would be beneficial.

Ms. HOFF-HAY. You bring up the issue of fairness and as far as fairness goes, indexing is much more unfair that someone would see their capital erode by inflation and then be paying taxes on that when they sell an asset.

Mr. PRYDE. It is my perception that a targeted elimination or significant reduction in the capital gains rate would probably, from the point of view of investors, be a stronger incentive to invest in the type of companies that I am thinking about than indexing, so I prefer the targeted cut rather than indexing.

Mr. POSHARD. I honestly don't think we are going to get a total elimination. I think reduction may be in order, hopefully, but it is interesting to get your viewpoints on the differences there between what might be possible. Madam Chairman, thank you.

Chairwoman MEYERS. Thank you, Mr. Poshard.

Mrs. Smith.

Mrs. SMITH. No questions. Thank you.

Chairwoman MEYERS. No questions at this time. Mr. Talent.

Mr. TALENT. Thank you, Madam Chairman. Let me address what my friend, Mr. Poshard, raised with regard to the fairness issue and that is usually raised in the context of who is paying, who is carrying the tax burden.

I will tell you a very brief story and then ask you to comment on the context of the capital gains tax, because it seems to me that with the existing system, we are getting neither efficiency nor investment nor fairness even in the sense that my friend talked about.

I talked to a person I know a couple of months ago. He is retired from a high corporate position, which he worked up, by the way, from basically from nothing and he has invested very wisely and his money works for him now and he doesn't need to work. He would like to work. He is in his mid 50's. He is a very productive person, but he said to me, explain what happens in the tax consequences of each extra dollar. He is paying about 50 cents of it up front to the Government between the income tax and payroll taxes and the rest.

Then, of course, he says I don't need the money so it is really going to my estate and when I die the Government will take more than half of it then. He says I can work a very high intensity job, as I always have my whole life and maybe my kids, the practical impact to me is my kids might get 20 cents out of every dollar, so I don't work that hard anymore. So, as to the fairness issue we are not hurting him.

I mean if the idea is to either hurt the wealthier people we are not hurting him. He is playing more golf. What is happening is the tax burden is having to be picked up by people who don't have that option, who have to work. The working people of the country, and, in addition, he is not doing the kinds of things that are producing income and opportunity for people. I know that this is happening also in the capital gains context.

So the point is we end up, it is perverse even if you are a redistributionist and you want to do that you are not redistributing anything. You don't get this layer of people. They just move the income into different lives and they don't produce as much. Please discuss that in the capital gains tax context.

Ms. HOFF-HAY. I believe that you have just described exactly what I see happening in the people who I work with in Arizona. For instance, the gentleman that I talked about who had closed his business. He is playing a lot more golf, but there are a hundred Ar-

izonians who have families who don't have jobs anymore and it is simply because it didn't hurt him, but he finally just said I can't keep the business going anymore. I can't keep those 100 people employed anymore.

Mr. TALENT. I have got other entrepreneurs who say I don't do a deal now unless it is ironclad. They don't go out and level a risk because the return isn't there for them. Again, it is not hurting them. Their life-style is unaffected. In fact, they are trading opportunities for more leisure time which, for them, is a more or less even trade on the margin.

Dr. GOODMAN. The problem with the whole fairness debate, is that people only focus on the first round and fail to ask what happens on the second, third, and fourth rounds. We believe in the long run that all taxes on capital are paid by laborers.

The Robbins, Gary and Aldona, who do research work for us, have gone back to the 1950's and calculated that for the U.S. economy as a whole, the real after-tax rate return on capital is 3.3 percent and it is amazingly constant. Whenever Congress has done something to lower the tax rate on investors, capital rushes in that rate.

If Congress does something to raise taxes on investors, then the flow of capital slows down and that rate is reestablished. If we already know how the capitalists are going to come out at the end of the day, who is really at risk here? It is labor. There is a very high correlation between the amount of capital per worker and the real wage, so investment in the economy mainly benefits people who earn wages.

It mainly benefits them through higher wages and that is where I think everybody ought to focus. What can we do to increase the real wage in the United States? The most important thing we can do is encourage more investment.

Mr. TALENT. We can have a progressive tax system and the more we flatten it out and encourage the right things in it, so we have a simple system at the end when we are taxing one time in the right way. If we want to do this as a matter of policy and you go to people not out of hostility, but in essence saying since you are doing better, we have encouraged you to do that and we have asked you to contribute a little more than other people who aren't and you will end up with a system that is more fair from the standpoint. More productive, more efficient, that doesn't demoralize people than the one we have now which basically ends up, as I said before, getting neither efficiency nor revenue nor fairness in the sense that is usually used.

Chairwoman MEYERS. Mr. Linsert.

Mr. LINSERT. To me, this issue is a matter of choice. What are you—what are people going to spend their money on. Are they going to invest or what are they going to do with it? Are they going to buy a bond or some sure thing?

You know 10 years ago at Martek when we were going around putting the original financing together basically we were telling investors we are in the biotechnology business. It is going to take a long time. Yes, there is an up side. There could be a tremendous up side, but you have got to be very, very patient and you know those folks sitting on the other side of the table looking at—listen-

ing to our presentation saying, my goodness, I have got to wait 5 to 10 years and maybe I won't see my money back. Maybe I will make a lot of money.

But to have taken that risk and to sit around, wait around, listen to the story for over 10 years and then make some money and then get it largely wiped out through taxation it just makes our task a pretty tough convincing job for us to go out and raise money at these early stages. So you know, again, people's appetite for risk is dramatically reduced when they see the up side taken away from them because they have an instant partner on success and that is the U.S. Government.

Chairwoman MEYERS. Thank you. Mr. Sklar.

Mr. SKLAR. There is one way to avoid tax contrary to popular opinion and that is if you die with an appreciated investment, you don't have to pay capital gains on it. That is not a great incentive, but we do have a lot of senior citizens in this country. Many of them have investments and are holding on to investments.

As a tax adviser to some of these people and I am sure other tax advisers are telling them let's hold on to these appreciated assets, any appreciated assets you have until you die because you get stepped-up basis and the reason for doing that is that the estate taxes are a tax that is in excess of 50 percent.

Capital gains tax is a tax that is 28 percent. When you put both of those together, you have a rate that is over 70 percent. It doesn't make sense to go and sell those types of assets before you die. So, I am in favor of reducing the capital gains. I think it will free up some liquidity in this country and raise tax revenues.

Chairwoman MEYERS. Thank you, Mr. Sklar.

Mr. Meehan.

Mr. MEEHAN. Thank you, Madam Chairman. I assume most of the panelists probably would support the balanced budget amendment that is being debated today. Probably.

I support the balanced budget amendment as well because I think economists have shown that 80 percent of the country's capital goes to what that company is able to save and further than that, one of the reasons why there is a lack of capital in this country is because most of our investments are tied up in the Federal budget deficit and the Federal debt so I happen to think that the balanced budget amendment is important, too.

But in the context of these tax and finance issues, I am also a supporter of a cut in the capital gains tax. One that is targeted; one that the country can afford. If you look at the proposals before us and we get estimates from the Treasury Department that potentially $61 billion in the first 5 years that it would cost. It is interesting to me why we can't find a way to come up with the proposal that the country can afford and is in the context of a balanced budget amendment.

You know, 28 percent of the Federal budget is discretionary spending. Only 28 percent. Half of that is defense spending and in the same Contract With America we are looking at increases in defense spending. In fact, we had a hearing before the National Security Committee yesterday on potential of increasing Star Wars that would cost $28 billion. So, I agree with a lot of what is being said

here, but I happen to believe here a balanced budget amendment is one of the best ways to free up capital for small companies.

I was the co-chair of a manufacturing task force that I started when I first got elected to Congress. We had a number of members that put together a proposal to increase manufacturing because I think a cut in the capital gains tax will, without question, have a positive effect on manufacturing.

Our proposal calls for a cut after 3 years. Securities invested 3 years or more goes to 23.5 percent and 19 percent for investments held 6 years or longer. I am wondering if you could react to that, but I also want to make the point that I am not sure how non-productive assets, cutting the capital gains tax, for example, on investments like coin collections where retroactively cuts have already been made.

Certainly, you can't influence investments that have already been made if you pass a capital gains tax cut retroactively. I also think it is very important to balance the budget and this notion of the rhetoric, and you hear a lot of rhetoric today about the balanced budget amendment, both political parties got us here. It is not one party or the other party. It is basically both parties contributing, so this year we paid $220 billion on interest, just on interest which would pay for all of these tax cuts that many of us would like to see.

I am wondering if I could get a reaction. One other point I would like to make because there has—I realize we have a vote just as—do you want to delay?

Chairwoman MEYERS. Go ahead. I am waiting for the 10-minute bell and then I thought we would break.

Mr. MEEHAN. You see a bidding war essentially between both political parties for tax cuts. It is popular this year with the elections coming up. But I really believe that it is important that we get to a balanced budget for real not just pass the amendment. Really look at the difficult choices that have to be made.

I am wondering if you could—the other point I want to make, there are estimates around that many of you had that a capital gains tax will actually increase revenues. I believe that if you target it long term, but we can't necessarily rely on Congress to come up with these estimates that it is actually going to increase revenue when we have data from all of the appropriate agencies that says, in fact, it is going to cost us money, so I wonder if you could comment, that is kind of a broad kind of observation and I am looking for a comment.

I don't think the country can afford the tax cuts that both political parties are talking about. I don't think we can balance the budget by pretending that we are going to cut waste out of it and not touch entitlements and defense and everything else and I believe that balancing the budget is nearly as important to increase capital for small businesses because the Government is in front of the entrepreneur in banks across the country getting the loans.

I am wondering if you could comment on how we can target it in such a way that it is consistent with really balancing the budget. I don't mean passing the amendment, which is easy, I mean really balancing the budget.

Chairwoman MEYERS. Mr. Meehan, I wonder if we could take a break and vote now. I have two more on my left and one more on my right that would like to ask questions, so you can be thinking about Mr. Meehan's question and we will be back in 5 or 10 minutes.

[Recess.]

Chairwoman MEYERS. Ladies and gentlemen, we will resume the hearing and I think we will have probably a couple more Members who will return. In the meantime, I would welcome the answer to Mr. Meehan's question and why don't we start at the opposite end of the table this time. We will start with Mr. Sklar.

Mr. SKLAR. I need some help. What was his question.

Mr. MEEHAN. To summarize it.

Dr. GOODMAN. I am ready to answer.

Mr. MEEHAN. To summarize in one statement. The capital gains tax cut for securities held long term, in my view, is a no brainer and I suppose my party, the Democratic Party, has been the biggest obstacle to that. But we need to get it done. I also think we need to really balance the budget not just the amendment.

I came to the Congress with a plan to balance the budget. We need to do that, so I believe it is important—I don't think the country can afford the tax cuts that both political parties are talking about. It sounds like it would be great to cut taxes by $100 to $200 billion.

What I am getting at is let's get a targeted cut at capital gains, investments to American companies, American manufacturing long term and let's get a bill that the President can sign and get it done and I am really frustrated by both ends of the spectrum on this. We need to get it done this year. I want you to comment on the notion of a balanced budget, its effect on increasing capital and making capital available for small businesses and how it meshes into these tax and finance issues.

Mr. SKLAR. I have always been in favor of balanced budget amendments. I don't know all the details that need to be there to get a balanced budget amendment, and I know what I am afraid of are the off-balance or off-budget type of things that we have done in the past and that would undo anything that we tried to do.

I think if we were able to balance the budget over a period of years it would have a beneficial impact on business and in general all kinds of businesses, because I think it would lower the inflation rate, which I think is beneficial to everybody. I do believe that cutting capital gains will create revenue and, therefore, I think it will contribute to balancing the budget.

Chairwoman MEYERS. Mr. Pryde.

Mr. PRYDE. I don't think there is any question that excessive public borrowing drives our private activity, so if you can reduce the extent to which the Federal Government needs to borrow and use and so it will have a beneficial effect.

As to capital gains, it seems there are a couple of ways to achieving the beneficial economic effects without achieving undesirable costs. One is to target very carefully so that you are not giving everybody, those who use money productively and those who don't the same benefit.

The second is to make a bargain with the people such as the one made by 1044 where we will give the tax break if you shift your money from relatively low-risk assets to relatively high-risk assets in small businesses. I think that is a pretty good bargain for the public sector to make with private savers.

Chairwoman MEYERS. Ms. Hoff-Hay.

Ms. HOFF-HAY. I certainly don't think that a balanced budget amendment and capital gains tax cuts are at odds with one another at all. The only problem that I have with targeted capital gains cuts is I don't want to see the Government in a position of trying to micromanage a $6 trillion economy and trying to pick the winners and losers in that economy.

Fiddling a little bit here and a little bit there, oh, I am not sure what the targeted capital gains proposal that you are talking about specifically is, but I just would hate to see Government trying to make investment decisions for investors as in maybe it is better for an investor to field like after holding an asset for 3 years is a better time to sell than 5 or investing in one type of industry is more important to them than another.

I know this Congress is going to be under tremendous pressure when you are talking about balancing the Federal budget from various special interest groups that are going to want to keep their own piece of the pie, so I certainly applaud you for having a balance-the-budget proposal of your own. But I guess it all comes down to the philosophical question.

The basic fundamental philosophical question is that for everybody to decide what is the proper role and function of Government and what is the proper size of Government and so if you believe that—that money is better spent by Government or better spent by families and individuals and businesses, which is more productive. That is the basic philosophical question that everyone has to answer.

Chairwoman MEYERS. I might mention before we go to Mr. Linsert that we just had a vote on whether our balanced budget amendment would have a provision that you had to have a three-fifths vote to increase taxes and it got 259 votes. We will now go to the other options. The one that has the most votes will then go to a final vote and, of course, has to have 290. So, we will see how that goes.

Mr. Linsert.

Mr. LINSERT. We are for the, of course, the notion to bring interest rates down by reducing Government needs for funds and, but that in the biotech business, our source of money is from equity capital because really we are not bankable right now. I mean, banks would have to be foolish to lend to us because we have a record of losses and these losses are naturally an outcome of our research and development. So, as far as an immediate effect or an effect on us for lower interest rates, we would probably not feel that too much.

But, again, we go back to the capital market and we do recognize and we propose a targeted issue here with the long-term capital gains. We are very much for that. You know, in my own company we are 10 years into this and the original investors are still in it and have never seen a dime back. They look at it in the paper and

they see their stock up in value, but most of them have never seen a dime back and here it is 10 years. So, this is really patient money and we hope that we can differentiate between this productive, long-term patient money from the idea of a flipper that one day comes in and buys something and the next day, through some inside knowledge or some excellent knowledge, just immediately turns around and resells and that is closer to income in our mind.

Chairwoman MEYERS. Dr. Goodman.

Dr. GOODMAN. Well, I am going to disagree with my colleagues here on a couple of points. First of all, it is a mistake made by both Democrats an Republicans to try to tie the size of the tax cut to the holding period. It confuses two entirely separate issues.

One issue is that our tax system discriminates against long-lived assets. It discriminates against long-term investments. To change that, we want to encourage people to go out and make investments that they are not now making. But once they build a factory and get the piece of equipment, then we have no public policy reason to care how long they hold that asset.

After it is constructed, if they trade it to someone else the next day, that is not a bad thing. In fact, if we structure the tax code so as to penalize trading of assets, then we make the capital market less liquid and we make these investments less attractive than they otherwise would be. So, I would strongly encourage you to have a tax cut that is unrelated to length of holding period.

Now, second——

Chairwoman MEYERS. Dr. Goodman, can I interrupt just for a second? Would you respond to the argument that without any kind of a holding period, this leads to churning in the market, maybe not a factory. I would certainly agree with you, once that investment is made in that kind of an asset, maybe we don't have as much interest in the time factor, but there has been some concern about people who just speculate and churn in the market and it makes everything so unstable. Would you just comment on that? I am not a market expert.

Dr. GOODMAN. We need to conceptually distinguish between the real assets and financial assets. Financial assets are traded on the stock market every day and there is nothing wrong with keeping that market liquid and encouraging people to understand that they can make trades as often as they like.

Our problem is with the real assets. This, by the way, is why neutral cost recovery is so important, which we haven't really talked about this morning. The current Tax Code penalizes long-term investments, investments in assets that have long lives. It discriminates against them because we force the owner of the asset to depreciate the investment, but we do not allow him to recoup what he loses over time because of foreign interest and inflation.

There are ways to encourage those kinds of investments to be made. That act should be separated from the trading back and forth of titles to assets. We want that market to be very liquid and we want people not to be penalized when they trade.

Now, I also would caution against the kind of targeted tax cuts that some of my colleagues have talked about. In general, the problem with the Tax Code, over the entire post World War II period,

is that too many investments have been made on the basis of tax advantage rather than economic advantage.

Government, wherever possible, it seems to me, should create a level playing field and not decide what is productive or unproductive. Not decide a small business is better than a large business. Make the rules the same for everyone. Don't penalize anyone. That is the best tax strategy.

Now, on collectibles I think the case for tax cut for collectibles is harder to make, but in general I think it is a wise thing to do. Let's not try to decide what is collectible or not. Let's have the same rules for all assets. You need to remember that an investment in a collectible like stamps or coins is not made at the expense of some other investment.

For an individual, it might be, but for society as a whole you only have so many coins. You have so many stamps. When people trade them, that is not taking away from investments in plants and equipment.

Why have a tax cut for past gains? I suppose you don't get more investment by doing that. But you do create more liquidity in the capital market and that seems to me to be not a bad thing, so I think the proposal as written is OK. Government probably gains from it because people will sell assets they otherwise would hold.

Finally, it is not clear that the Federal deficit crowds out the private investment in the United States. The studies really don't show that and one of the reasons I think they don't show it is because deficit is really a very, very small part of a very huge capital market.

Deficits in the range of $100 to $300 billion a year sound large, but the capital stock in the United States is something like $17 trillion and that is not really the extent of the capital market. We are in a world capital market which is many times greater than that. So, our Federal deficits are small in relation to the total market. Therefore, I think the deficit should go down. I want a balanced budget, but I can't argue that if we get it we are going to get more investment because of that.

Chairwoman MEYERS. Thank you, Dr. Goodman. Mr. Chrysler.

Mr. CHRYSLER. Thank you, Madam Chairman. I support elimination of the capital gains tax and I guess I would ask anybody that would like to answer, are you testifying today for a reduction in the capital gains tax because of the political climate and you feel that is all you will get or honestly do you believe it should be eliminated and what would it cost to eliminate it?

Dr. GOODMAN. Well, I am in favor of its complete elimination, but you have to admit that if you completely eliminated it, the Government really would have a loss of revenue. Even the chart I brought shows that if you couldn't tax any realizations, Government would have a loss of revenue.

I think it is a price worth paying because I think the capital gains tax interferes with the capital market. It really is a transfer tax. It penalizes people for transferring assets back and forth. Real investment income ultimately would be taxed anyway. So, it is an unnecessary tax. It interferes with capital markets. Other countries don't have it or they keep the rate very low. I would be in favor of going all the way, but there would be a revenue loss.

Mr. CHRYSLER. Anybody have any idea how much?

Mr. LUDLAM. The question of what an across-the-board cut would do if it applies to previously acquired assets is a matter of considerable debate and I think we view it as an economic debate within the Joint Tax Committee and between the Treasury. The Joint Tax Committee is one I think you have to leave to people who are immersed in that debate.

In terms of targeted capital gains incentive, we know it has a quite modest revenue loss no matter how you score it so even if the score is positive, meaning that it loses some revenue, there is a small amount in the scheme of things. So, it is not an impediment to enacting it into law.

In terms of the benefits, I think it is clear. We make choices in the Tax Code. We provide a home mortgage deduction. We make choices all the time. We don't have anything like a tax system which is neutral in a general sense. It is not neutral at all. It makes choices between dividends and capital gains and all kinds of other choices.

The question is whether those choices are the best ones in the scheme of things to generate the most growth and the most jobs and the most economic activity which will benefit the larger society. Certainly from the biotech industry point of view we are dealing with industry that has a real prospect for finding cures not just therapies, but cures for Cancer, AIDS, Alzheimer's, debilitating diseases on the cutting edge of science doing basically Nobel quality science with an incredible risk. That kind of an activity I don't think is controversial in terms of whether we should encourage it.

Ms. HOFF-HAY. The Small Business Survival Committee also would be totally in favor of eliminating the capital gains tax, but I don't have the numbers as to what that amount would total.

Mr. PRYDE. One can approach this issue looking at how to make the tax system more neutral or how to make capital markets work more fairly and efficiently with respect to small businesses by using tax policy. I come at it from the latter perspective.

My view is therefore if—one can use targeted capital gains tax cuts to solve a condition market problem that almost every researcher and scholar has studied and small businesses exist if one wants to tackle a tax system at large.

To make it neutral with respect to different activities in investment you probably would have to go beyond capital gains tax cuts. That is not a battle I want to take on. I don't know how much an across-the-board capital gains tax cut would cost, but I think it is generally agreed that targeted tax cuts have marginal budgetary effects.

Chairwoman MEYERS. I think the 50 percent cut that is in the contract bill with indexing envisions a $63 billion cost over 5 years.

Mr. CHRYSLER. Yes.

Chairwoman MEYERS. Over a 5-year period. I think we have been told in the past that initially capital gains will show a positive effect and then later, of course, there is revenue foregone, but over the 5-year period I think it is a $63 billion loss. That and the $500 per child tax credit are the two most expensive items, I believe, in the contract.

Mr. CHRYSLER. Thank you.

Chairwoman MEYERS. Thank you. Mr. Bentsen.

Mr. BENTSEN. Thank you, Madam Chairman. I have a couple of questions for some of the panelists I would like to go through.

I think it is interesting, Dr. Goodman, on your comment about deficits, I came from the financial markets to this job and while I think you are accurate that the size of deficit is small compared to the total capital markets and world capital markets, credit markets seem to get concerned whenever they think the deficit is going up and that may just be the fickleness of the capital markets themselves or the traders.

I also would want to just make an observation with respect to the idea of when we are talking about targeted versus nontargeted and you know that your comment that it is probably not efficient that the Tax Code—or that you invest based upon incentive versus investing based upon fund for growth and income return. However, I don't or do think when we are talking about a capital gains tax reduction we are talking about some sort of incentive.

When we are talking about—when we look at the code as a whole as you correctly mentioned, it is full of incentives to direct investment one way or another, whether it is home mortgage interest deduction, whether it is a tax exemption for municipalities, whatever. We had a discussion the other day when we talked a little bit about so-called corporate welfare and I know one of the panelists, a tax attorney, felt that that was a misnomer. I take some issue with that. I think that you could call it corporate welfare or a revenue side expenditure.

Let me ask a couple of questions and I would like to go through them briefly because I have another question for Mr. Pryde, which I thought was very interesting, which I caught on the tail end of his testimony which is a little bit different from what we are talking about here.

With respect to indexing, I understand how that would apply to your basis for the gain calculation. What impact would you see and Mr. Sklar may have a comment on this as a practitioner, what impact would you see that that would have on loss? Would that exacerbate the charge-off for loss? Is that something that you all are considering when you are discussing this?

Dr. GOODMAN. I don't know how the indexing provisions relate to losses. I do know we don't treat gains and losses equivalently in the tax code. I think this is a mistake. From an economist's point of view you should treat them both the same. This is one reason why other countries are reluctant to tax gains because they don't want to give the write off for losses.

There are problems with doing that. If you give people opportunities to game the system then you may end up with the Government not collecting any revenue because people hold back on their gains and realize their losses.

Mr. BENTSEN. If I could ask very quickly one other question before we go on, because I think we talked about the capital gains. Mr. Pryde, you mentioned something that I am very interested in and that is the creation of a secondary market for small business capital formation and you mentioned the idea of looking at Fannie and Freddie and seeing if they would more or less put those types of loans in their portfolio or wrap those types of loans and use the

equity, which I think you will find a lot of resistance from Fannie and Freddie to do that, although I think it is something that I would hope this committee would take a look at. Not Fannie and Freddie per se, but the idea of some sort of secondary market vehicle.

If you look at what the States have done over the years, you have seen a number of States combine their housing finance with their other economic development agencies because that is generally where the equity has been in order to create a forum to provide some credit enhancement and therefore create a secondary market vehicle and I would hope that is something that we would look into. I would be interested to talk to you about this as well at any time.

Mr. PRYDE. I think that is a very promising area. We just finished doing some work in that area, doing a transaction and we found there is a lot of demand at the State level, for example, to liquefy portfolios in which public money is no longer flowing.

We found there is a huge demand by investors for some security backed by economic assets and the real problem right now is that no money is going into the financial engineering work that needs to be done to create that market. I don't think—I think a relatively small expenditure on the part of the Federal Government could unleash billions of dollars of capital for investment in small business-backed security.

Mr. BENTSEN. I think it would be more efficient than direct loan type of expenditures, as well.

Mr. PRYDE. Absolutely.

Chairwoman MEYERS. Thank you. Mr. Tucker.

Mr. TUCKER. Thank you, Madam Chair. As to the argument that creating tax cuts and capital gains would be a fiscal time bomb, what are your reactions to that?

Dr. GOODMAN. That the models that predict are wrong. They have been wrong in the past. In 1986, when we raised the capital gains tax rate, the CBO and the JCT and the Treasury all predicted, all for the same reasons, that realizations would continue to increase and that Government revenues from capital gains taxes would go up.

As you see from this chart down here, all that happened was that right before the tax increase a lot of people rushed out and sold assets at the lower rates. Beyond that we didn't get the increased realizations that were projected.

When we raised the rate, Government got less revenue and even today realizations as a percent of national income are lower than they were back in the 1970's. So I would flip the chart around to predict what would happen if we cut the capital gains tax. I would expect more realization and more revenue for Government.

Mr. LUDLAM. If I may make one comment, there is an intermediate effect going on now because of the anticipation that there may be a capital gains tax cut of some design and the question is what will the effective date for that be?

Will it apply to previously acquired assets? Will it only apply to newly acquired assets? Will there be a differential? And I think you have some effect of freezing investment or sales or investment on both sides at this point. I think it would be a very constructive

move for the Congress to move quickly in this area particularly on the question of what effective dates will apply because you are getting perverse effects on the market today because of the speculation about what will happen in the Congress.

Mr. TUCKER. What is your particular recommendation as to its application, to apply or should it apply——

Mr. LUDLAM. In terms of target incentive, the biotech industry is in favor of both an across-the-board incentive and we are endorsing the contract provision on that. In terms of the targeted incentive just for direct equity investments in a small company, we are happy for that to apply only to newly acquired assets so on that question it would be important to set the effective date as early as possible.

We are not asking for a retroactive application of a target incentive. We think we want new money. What we need is new money not sale of old assets in terms of that incentive.

Mr. TUCKER. Any other responses? Thank you, Madam Chairman.

Chairwoman MEYERS. Thank you, Mr. Tucker. I am not sure whether Mr. Thompson or Mr. Hilliard arrived first. I am trying to call in order of appearance.

Mr. HILLIARD. Mr. Thompson.

Chairwoman MEYERS. Mr. Thompson.

Mr. THOMPSON. No, Madam Chairman, I don't have any questions.

Chairwoman MEYERS. Mr. Hilliard.

Mr. HILLIARD. I have none. Thank you.

Chairwoman MEYERS. And finally, Mr. Flake.

Mr. FLAKE. Thank you very much, Madam Chairman. I have no questions today. Thank you. I think I talked enough yesterday.

Chairwoman MEYERS. You did very well yesterday. We will adjourn then. I want to say, again, how much I appreciate—can I take that back? Can I ask one question and I hope this one is fast to answer because I know that you have been here a long time.

Mr. Sklar offered a plan for a targeted capital gains plan. I wonder if you would comment on what you think about that, Mr. Sklar, if need be. Would you refresh us on the details of that?

Mr. SKLAR. OK.

Chairwoman MEYERS. As I understand it, is this the position of the National Small Business United.

Mr. SKLAR. No.

Chairwoman MEYERS. This is just your thoughts.

Mr. SKLAR. This is mine because I want to—we need incentives for people to invest in the small business, to take the risks, but we want to make sure there aren't any abuses. What it is is an immediate tax deduction for an investment in a qualified—and, of course, we always need a definition of that—but a qualified small business with limitations on it to hold back abuses, limitations on the amount an individual can deduct on an annual basis under joint returns so we don't create tax shelters and partnerships and everything else to do this.

People have to hold on to their investment for a 5-year period. During that period they can take zero payment in any form at all.

They can't take any salary. They can't take any rent, dividends, commissions, any royalties, or anything.

Chairwoman MEYERS. Thank you. It sounds as if it is a fairly narrow—well, it certainly would call on people to be patient. They can take no payments of any kind for 5 years. There is a limitation, then, on the amount that they can take under the capital gains and it is limited to 25,000 on a return; 50,000 on a joint return.

Mr. SKLAR. Right. On an annual basis.

Chairwoman MEYERS. Would you all comment on that? There is a lot of different plans about how to narrow this, how to target it. Mr. Pryde.

Mr. PRYDE. I very much like Mr. Sklar's proposal. I am aware that a similar proposal has been advanced before I think by Congressman Rangel. It was limited for budgetary and economic reasons to certain eligible—businesses in certain eligible areas. The advantage of that is that it gives those eligible areas a head start on the rest of the country and it reduces the costs. But the idea, I think it has a lot of merit and probably would gain broad acceptance.

Ms. HOFF-HAY. While the proposal certainly does have merit, I would agree, a couple of problems arise. One is we already have an incredibly complicated tax system. This adds more complexity to that.

The second thing, again, it puts Government in a position of picking who the winners and losers are of micromanaging the economy and so we would have some concerns about that. The Small Business Survival Committee would far rather see the reduction or elimination of capital gains tax across the board.

Mr. LUDLAM. Madam Chairman, there is some history of this in the Congress which I will be happy to report. A proposal for an up-front deduction on the purchase of small business stock was actually included in the budget deal between President Bush and the congressional Democrats in 1990.

Reportedly, it came from John Sununu and it was his idea. Provided an up-front deduction when you buy the stock. It was not a gains provision. You didn't have to hold the stock and have gains. You simply had to make the investment. There are other restrictions applied to it. It was scored by the Joint Tax Committee as losing $5.7 billion over a 5-year period.

Within about 2 days after it was included in the agreement of all things, the Wall Street Journal wrote a front-page column, the entire right-hand column analyzing this proposal. At length in terms of a program in Quebec Province in Canada which was a similar up-front deduction which reported that there had been scandals connected with the proposal in terms of people making investments without any expectation of gain and simply doing it because of up-front deduction. When the Wall Street Journal analyzed it in that way it did not have a very long life on the Congress.

Chairwoman MEYERS. Dr. Goodman.

Dr. GOODMAN. I hate to speak against tax cuts. But this is a tax cut idea that I think, along with most other targeted tax cuts that we have been talking about this morning that, in general is a bad idea. I do not think you should give people a deduction for the purchase of stock. I am in favor of an immediate write-off for the pur-

chase of capital assets. That is real capital as opposed to pieces of paper.

Most economists, by the way, are in favor of immediate write-offs for capital investments, but that would cause a loss to the Treasury and that is the real reason for the neutral cost recovery proposal in the contract: To create the equivalent of an immediate write-off without having that huge revenue loss in the first year.

I have already said I think holding periods are a bad idea. We want people to make investments in real capital. Once they make it we want them to be free to sell the asset to other people and the holding period should not affect the tax advantage.

Finally, I agree with the previous statement. We shouldn't try to direct investment in one place or another through the tax law. The tax law should create a level playing field and let investments compete with each other on that level playing field.

Chairwoman MEYERS. Finally, we will take 5 more minutes to hear a question from Mr. Wyden on capital gains.

Mr. WYDEN. Well, Madam Chair. Thank you. I apologize for missing this because this is extremely important and I testified yesterday before the Ways and Means Committee in favor of a capital gains differential. I really just want to ask you about one issue.

There are probably only about 11 Democrats left like myself who voted for Mr. Archer's capital gains tax break some years ago. We are very interested in getting one out of this Congress that the President is going to sign. The problem, as we saw yesterday, before the Ways and Means Committee is sort of a competition between studies.

The Democrats nearly always cite studies that say, well-to-do people get a good portion of the capital gains benefits. The Republicans cite studies that show most of the capital assets are owned by people with $50,000 or less in income.

I personally think that the Republican studies on this point are more accurate. Well, that is where I come down, but I am not sure that is the question. The question is how are we going to come up with a way to bridge the gap between the two parties and actually get something signed?

I have proposed that we essentially treat this like a home rollover. You know, if you sell your home, you take your proceeds and roll them into our home. America has said home ownership is special; the tax man won't come. We could do the same thing for small business.

You sold your small business, took a portion of the proceeds and rolled them over into another small business. People would actually see the jobs. My friend, Mr. Flake, who has been very interested in this issue over the years could see in his inner city like mine, that capital gains was directly tied to job creation.

I think if we could do that we are going to get this done and my fear, again, having been one who voted for Mr. Archer's proposal last time is that as of now we are sort of gridlocked between the two parties. We got to come up with something, if we want to get this signed, that ties capital gains to reinvestment. If you all could in my time give us any thoughts you have to get that done, I think that is what the challenge at hand is all about.

Mr. LUDLAM. Congressman Wyden, I represent the Biotech Industry Organization and we are aware of your roll-over provision and we believe you developed in part with the Oregon Biotech Association and our proposal on a targeted capital gains includes a roll-over provision.

I believe in your bill the limit is, for sale, a company with sales of $20 million or less with an industry that has very little in the way of sales. That certainly would apply to the vast percentage of the companies in our industry. The targeted capital gains incentive that was in the 1993 budget bill deals with $1 million in capitalization, a different concept. We would be happy to work with you on the concepts that you have outlined.

Dr. GOODMAN. Let me say just generally we have got to get past this income distribution argument. It is a fact that people who earn more than $250,000 a year receive about 65 percent of their income from investments. People who earn more than a million dollars a year receive almost all their income from investments except for maybe entertainment and sports figures.

People who have high incomes invest. That is a good thing and so what our national policy should be focused on is how do we get them to invest in the United States versus sending their capital overseas. In the 1980's, a lot of investment was financed by repatriation of capital because we made it more attractive to invest here. We have to remember that on the average, every time an investor takes a dollar home after tax and puts it in his pocket, wage earners take home $12, so 90 percent of the benefits of new investment go to wage earners, not owners of capital.

There is a very high correlation between the amount of capital per workers in our economy and the real wage in our economy. So, this has got to be seen as something that benefits labor and I think it does. The only way we are going to get the real wage up substantially in our economy is with more investment and it shouldn't matter who the investor is, whether it is a little old lady in tennis shoes or the Japanese. As long as they get a dollar and we get $12, that is a deal we can't turn down.

Mr. WYDEN. I largely agree with that point of view. The problem, there are enough Democrats in the Congress who don't agree. If the President vetoes a bill based on that premise, we can't override a veto. So, the question then becomes can we come up with something in this debate that will bring the parties together?

Mr. Archer just visited me on the floor a minute ago. He has some attractive gains. He is talking about making the capital gains zero in the inner city where we can see it tied for investment. I gather that he has not proposed that, but others have in the Ways and Means Committee, and I just want you to know that there are a lot of us on the Democratic side who want to meet you more than halfway. We showed that having voted for Mr. Archer before. The test this time is how can we come up with something that the President actually is going to sign and I know my time is up, but I think that gentleman may want to respond.

Chairwoman MEYERS. Mr. Pryde.

Mr. PRYDE. There is, as you know, an existing roll-over provision in Section 1044. However, that requires the taxpayer, in order to qualify for favored treatment, to sell a publicly traded asset.

As I understand what you would do is apply the treatment to proceeds of any assets. The other requirement is the proceeds have to be intermediate to a small business qualified through SSBIC. The question I would have is whether by expanding the treatment to a wider range of assets and a wide range of transactions you would undermine the intended benefit to SSBIC's and therefore to minority business. If that weren't the effect, I think you are halfway home already.

Mr. WYDEN. Those are the issues for deliberation, Madam Chair. I came late and I didn't have my manners on display and you were nice to give me a chance to ask some questions. But I think this is one of the most important issues in front of the country because this goes to the growth question. This goes to the question of do we reward risk-takers and there are an awful lot of folks on the Democratic side of the aisle who want to work with people like you and Bill Archer to get this done and get it signed.

Chairwoman MEYERS. Well, we welcome your help. That is certain. Can I take a prerogative and ask your forbearance one more minute, because Mr. Hilliard has decided he would like to ask a question. Mr. Hilliard.

Mr. HILLIARD. Thank you very much, Madam Chair. I have two questions. One of them requires a short answer and if I can get the answer, I may not have the necessity to ask the second question.

The question is, sir: When you talked about tax deductions that should not be used to satisfy public policy, were you talking about inside of the United States or outside of the United States?

Dr. GOODMAN. I don't remember which comment you were talking about.

Mr. HILLIARD. When we were talking about directing deductions on investments in specific areas.

Dr. GOODMAN. As a general rule, I think it is a bad idea to use the tax system to encourage people to invest in one place rather than some other place, on one kind of equipment rather than another or one size business rather than another size business.

Mr. HILLIARD. You are talking about internally.

Dr. GOODMAN. Yes.

Mr. HILLIARD. Let me ask the question, then, and I would like to have a response, if I may, from Mr. Paul Pryde because of recommendations he set forth on page 4 under item two in his presentation.

Oftentimes we have made certain concessions—well, first of all, tax. The reason we have a taxation policy is for income or revenue. But oftentimes we have used tax to satisfy other—taxes to satisfy other types of public policies. I remember in Alabama we taxed cigarettes to death because we wanted to get rid of them and some other things. We got a tax on marijuana and so forth in Alabama. We thought that would help, but it hasn't. But at any rate, even on the national level, we use it for other types of reasons.

Now, I want to make sure I understand you. You do not think that as a matter of public policy we ought to give tax credits or tax deductions in order to satisfy—well, in order to encourage investments or risk-taking in inner-city areas?

Dr. GOODMAN. Generally, but a fair disclosure here. I am the person who really developed the idea of the medical savings account

and I hope this Congress passes it and that is the use of the tax system to encourage something. I am also——

Mr. HILLIARD. That is using tax for public policy.

Dr. GOODMAN. I am generally in favor of the concept of the enterprise zone. I would like to see us focus more on regulations than on taxes, but nonetheless, I am not against occasionally using the tax system to achieve some well-defined objective.

What I think is a mistake is to try to second-guess the market and decide that some kinds of investments are better than others or one size business is better than another size business because then you are just encouraging people to make investments based on tax advantage rather than the economic advantage. You get a less efficient economic system.

Mr. HILLIARD. But we had achieved the public policy then; is that correct?

Dr. GOODMAN. If there is a clearly defined public policy objective. Some of the proposals that have been put on the table this morning are not very clear what the objective is.

Mr. HILLIARD. All right.

Mr. PRYDE. Well, the idea that I proposed very similar to Mr. Sklar's was to quarantine the chances of abuse within certain areas as well as the benefits thereby to reduce the public risk. I mean if you say, well, we are not exactly sure whether this idea of deducting 60 percent of investments in qualifying small firms is a good idea. All sorts of horrendous things might happen in terms of the abusive transactions.

One of the ways to find out if that will occur is to put it in areas where you can monitor transactions over a period of time and find out if, in fact, the abuses some people fear will occur do develop. If they do, then you have a chance to manage them. If they don't, then you will get better effects, the sort of beneficial economic effects you want and the beneficiaries of those economic effects will be the people you want to benefit; that is, people living in inner cities, businesses in those areas, so the idea was to let's—to test the idea within a defined area under defined circumstances, see if it works as I expect it would.

Now, I could be wrong and abuses could occur. In that case the Treasury and the Internal Revenue Service would have by means of requiring information returns and other measures a way of correcting those abuses making sure the incentive works as hoped.

Mr. LUDLAM. There has been quite a bit of debate on some of the questions of the targeted capital gains incentive. For example, the question of whether it should only apply to equity. Equity is relatively easy to know when you have stock in a company. There are different kinds of stock, common, preferred, whatever, that is not a question whether there is potential gaming.

There are questions of whether you could divide up a large company into a series of small companies in order to qualify. That is something that is very easy to take care of in the Tax Code actually because there are definitions of when a company is a consolidated company before a return and when it is later a consolidated company.

There are rules in the Tax Code that you can play with that will prevent division of a large company into a series of small compa-

nies. There are also ways to deal with the question of redeeming old stock, which might be before an effective date and issuing it again as new stock. There are ways to deal with that problem. There are a series of issues of potential abuses that can be identified in the targeted capital gains area where there were very astute and quite effective solutions.

Mr. HILLIARD. Thank you.

Chairwoman MEYERS. All right. I thank you all very much. I personally at this time favor the most general kind of capital gains cut that we can get, but I do know that we are very determined to pay for everything we do in the contract and I don't know what this is going to mean in terms of ultimate narrowing of any of these issues. So, we appreciate your ideas and we thank you very much for being with us.

[Whereupon, at 12:28 p.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

Statement of

HONORABLE JOHN J. LaFALCE
RANKING MINORITY MEMBER

Small Business Committee
January 26, 1995

The Committee's examination this morning of tax provisions in in **H.R. 9, the Job Creation and Wage Enhancement Act,** will focus on proposals for a 50 percent exclusion on capital gains and a neutral cost recovery system that will increase the value of investment depreciation.

Without going into details regarding the way this will be accomplished, I am troubled by the impact this will have on federal revenues as well as the broad-brush approach taken as a means to encourage investment.

First, according to estimates by the Treasury Department, the proposed capital-gains tax cut will cause a revenue loss of $61 billion in the first five years and $183 billion between 1995 and 2005. Treasury reports that the Neutral Cost Recovery System will cost $120 billion in lost revenues over the next 10 years.

This revenue loss will create extreme pressures on an already untenable budget deficit. If we should pass a balanced-budget amendment, the prospects for program cuts and greater economic hardship on working Americans is enormous. I believe it is difficult to justify giving generous tax breaks to corporations and wealthy individuals at a time of fiscal austerity when we may be forced to cut certain government benefits and otherwise impose enormous burdens on average citizens.

Second, these tax-cut proposals provide across-the board tax reductions in the generalized hope of creating more savings, investment, and jobs, without any assurance we will achieve specific policy goals. Studies by Treasury, the Congressional Budget Office, and Congressional Research have concluded that capital-gains tax cuts have very small effects on savings, investment, and economic growth. Relying on such tax cuts to stimulate sufficient growth to ensure the creation of well-paying jobs is far too amorphous and uncertain an approach, and will only heighten expectations that cannot be met.

When adopting fiscal measures to encourage investment, I believe we should take a targeted approach. We know, of course, that all investment is not created equal. We must decide if we want to encourage investment in, for example, high-tech industries as opposed to real estate development. We may want to encourage long-term holdings of capital investment. We certainly want to focus on investment that enhances productivity and creates well-paying jobs. We should shape our tax policy to meet our investment objectives, objectives that meet the goals of society as a whole, not just a small, and already wealthy segment of it.

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Opening Statement of the Hon. Marty Meehan

Small Business Committee Hearing on Capital Gains Tax Reform

January 26, 1995

Good morning. I want to thank our witnesses for joining us today to share their insight on the impact that a capital gains tax cut may have on small business.

Fundamentally, I agree with many of you. I believe that for far too long small businesses have been trapped in a painful credit crunch that has limited venture capital availability and created an unfavorable investment climate in this country. Our nation continually lags behind in its rate of savings and investment. It is imperative to achieving long term growth that we find ways to encourage economic growth and discourage speculative spending.

While I believe that a closely drawn capital gains tax cut can encourage this type of growth, I believe the cut in the Contract with America is too costly to the Treasury and will not encourage the workplace productivity that we need. Any cut in the capital gains tax rate must be targeted to exclude non-productive assets.

During the last Congress, Rep. Bob Franks and I launched the Northeast-Midwest Congressional Coalition Manufacturing Task Force because we believe the U.S. and global economies are experiencing rapid and fundamental economic change. We also believe that to effectively compete in this new global economy, U.S. workers and companies must be equipped to deal with rapidly changing technology and to create and sustain the high levels of knowledge required in this global economy.

The bipartisan Task Force developed 40 legislative proposals -- most of which are specifically designed to help small manufacturers. Among them is a targeted long term capital gains tax cut. Our cut calls for the establishment of a long term capital gains tax rate cut: to 23.5 percent for productive assets held for three years or longer; for assets held six years or more, the rate would drop to 19 percent. The cut would be aimed at investments in manufacturing and indexed for inflation.

I believe that this cut will help increase competitiveness and job creation and will have the effect of making more capital available to small business.

Thank you. I look forward to hearing from each of you today.

STATEMENT OF CHAIR JAN MEYERS

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

- FULL COMMITTEE HEARING -

"SMALL BUSINESS AND THE CONTRACT WITH AMERICA: ENCOURAGING INVESTMENT THROUGH CAPITAL GAIN TAX REFORM"

The Committee will come to order:

This morning the Committee will continue its examination of the Contract with America, focusing on the capital gains tax reduction. This provision provides a 50 percent, across-the-board reduction in the capital gains tax, and indexes the value of the asset for inflation, to prevent the tax from being levied on illusory gains.

I strongly support this provision in the Contract as a way to encourage investment in small business, and as a step towards eliminating the federal tax policies we have in place that penalize savings and investment for the future. Jerry Heaster, a columnist for the Kansas City Star who brings a great deal of common sense to these issues, wrote a piece for the January 15, 1995 edition of the Star which discusses this very issue. Currently, persons who spend every after tax dime in their pocket are wiser, from a tax standpoint, than those who put some of their after-tax dollars into savings and investment, because the earnings on any savings and investment is taxed again. We provide few advantages through the tax code for people who save for their future, or invest in companies that could improve the future of many through new employment opportunities, and new products and services needed in our society.

The witnesses with us today have varying points of view on the issue of capital gains taxes, but all agree that their should be some reduction or elimination of capital gains. Some favor an across-the-board reduction policy, others a more targeted

approach. However, I think its important to point out this widespread recognition of the need to reduce capital gains taxes. As those with us will point out, with the authority of statistics, capital gains taxes are not a matter or concern of the rich. Approximately 75 percent of all capital gains taxes are paid by those with incomes of less than $75,000. Over half of all taxpayers with capital gains in 1992 had incomes of less than $50,000. The capital gains tax affects countless Americans, directly and indirectly, and it's time we reduced its anti-investment impact.

STATEMENT OF THE HONORABLE KWEISI MFUME

ON TAX CUT PROPOSALS CONTAINED WITHIN THE

REPUBLICAN "CONTRACT ON AMERICA"

January 26, 1995

Thank you, Madam Chair, for holding this hearing today on some of the tax provisions included in H.R. 9. As we are all aware, changes in the tax code can have very serious repercussions on our national economy, and for this reason I am especially glad that we will, today, have an opportunity to begin to look at some of the proposals.

Given the importance of small businesses to the American economy, it is very appropriate that this Committee review some of the Contract's tax proposals. While I have some larger concerns about who will benefit from the proposals before us, as well as who may suffer as a result of the loss of revenues to the federal government, I am also concerned about the impact these proposals will have on small businesses.

Specifically, I am concerned about the motivation, or lack thereof, for the people who will benefit from these proposals to reinvest their gains in small or emerging businesses.

While I am well aware of the problems caused by the persistent lack of capital for small businesses, I have not yet been convinced that the proposals before us will do anything to steer this money into small businesses.

Last year's reconciliation bill contained a provision which provides a 15% tax credit on long-term investments in venture capital funds that are invested in or loaned to a minority-owned business. I am curious to know how these proposals, especially the reduction in the capital gains tax, will affect proposals such as this which are intended to motivate venture capitalists to invest in small minority-owned businesses.

Would not this provision decrease, if not eliminate the motivation to invest in minority-owned businesses that was established in the 1993 legislation?

The irony is that we are considering these proposed cuts a day after we

heard testimony from SBA Administrator Lader about the problems facing the 7(a) program due to a lack of funds. Because I have not heard how we propose to pay for these reductions in revenues, I have concerns about the long-term impact of these proposed cuts, which would result in a loss of revenue to the federal government, on programs such as SBA's 7(a). as I am sure we all remember, the 7(a) program received glowing reviews not 24 hours ago.

So I thank you, once again, Madam Chair, for calling this hearing and for allowing us to begin to look at the issues surrounding the proposed tax cuts.

Statement of the Honorable Ron Wyden
U.S. House of Representatives

Tax Reform and Small Business Hearing
Committee on Small Business
January 26, 1995

Madam Chairwoman, thank you for convening this hearing today.

I want to talk about the Entrepreneurship Promotion Act, legislation I have introduced to provide targeted capital gains tax relief to boost small, fast growing, job creating companies. Than legislation is about main street rather than Wall Street.

These companies will be crucial components of sustained job creation in the 1990's. Small firms have consistently led America's technological charge, creating new technologies and products and high wage, high skill jobs. In my home state of Oregon, perhaps the most predominantly small business state in the country, 98% of the businesses employ fewer than 100 workers, and the state projects that fully 70% of the state's job creation in the 1990s will come from those small firms.

My legislation will create a tax rollover, similar to the one available to homeowners, to enable an investor who sold his or her stake in a qualified small business to reinvest the money in another qualified small business and defer paying taxes on the capital gain.

With this bill, investors will have an incentive to keep their money in the productive sector of the economy, rather than simply cashing out their investment. Moreover, the bill would target the incentive at investments in firms with less than $20 million in annual sales -- those companies with the fewest financing alternatives and therefore most in need of venture funds.

At some point, nearly every small business faces a crisis in finding the capital necessary to finance continued growth. Nearly every company gets caught in the awkward position of being too large to be financed internally, but not yet large enough to tap the public capital markets or adequate bank financing. Capital is the lifeblood of every small company, and without sufficient capital, an otherwise healthy small company with a great product line will be doomed to wither away.

In Oregon, for example, with its fast growing software, computer, environmental, biotech, wood products and other industries, numerous companies that could be global competitors and create thousands of jobs are at risk, simply for want of sufficient capital to fund early growth.

Let me share with the Committee a recent Oregon example. One firm, after three years and $8 million in start up funding, ran out of money just as it sought government approval for its product. According to the CEO, "No one else in the world had a comparable product, and the market was there." Thus, with no capital available, this Oregon firm went from potentially being a $40 million company to zero. I hear similar stories at home in my District on a regular basis. And I am sure, Members of this Committee have also heard this tale of lost potential, lost innovation and lost jobs.

It is imperative to pump more funds into the venture capital pipeline and to direct more of those funds to the companies that really need them. The Entrepreneurship Promotion Act is designed to do that by creating a tax incentive to get more investors involved -- and keep them involved -- in starting and growing job-creating small businesses.

There is no doubt that adequate venture capital is key to job creation. According to a Coopers and Lybrand survey, venture backed firms created more jobs and invested a greater portion of equity in research and development than the Fortune 500 companies of America between 1988 and 1992.

- Venture backed firms expanded their workforces by 19 percent a year, on average, while the Fortune 500 cut their workforces by .08 percent.

- 55 percent of the positions created by venture backed firms were skilled jobs, nearly four times the 14 percent formed in the U.S. economy overall.

- Venture backed firms invested $14,000 per employee on research and development, double the per employee expenditure of the Fortune 500 firms.

- Venture backed firms also invested more than twice as much of their revenues in plant and equipment than the Fortune 500 companies.

Venture capital has been instrumental in the development of leading edge technologies in this country. Microsoft, Intel, Genentech, Apple, Digital Equipment, Federal Express and Lotus Development all relied on venture capital financing. Today, the founders of these firms are some of America's premier venture capitalists.

My legislation is not about the search for the next Microsoft. The Entrepreneurial Promotion Act is about the other thousands of small developing firms in this country who make everything from paper bags to the newest computer games.

Madam Chairwoman, there is precedent for my legislation. Specifically, the precedent is a small provision with the Omnibus Budget Reconciliation Act of 1993 allowing investors to rollover capital gains on the sale of stocks and bonds into Specialized Small Business Investment Companies or SSBIC's. My rollover proposal is similar in principle but less regulatory burdensome. Further, it will offer capital gains tax referral to a broader spectrum of businesses in the early stages of start up, development and production.

The Entrepreneurial Promotion Act will provide significant relief to those small businesses with good products and good management but are starving to death for lack of capital.

On a final note, I would urge that the Committee, in considering its broader capital gains proposal, ensure that we have a formula that encourages better forest management and more private timber production. At the moment, we have a tax code that does neither.

In Oregon, for example, we have some 22,000 small woodlot owners growing trees on approximately 3.5 million acres of woodland. This resource is quickly becoming the backbone of our timber resource in the state. Thousands of mill jobs will depend on whether these lands stay in timber production. Unfortunately, because we have removed the capital gains differential and other adjustments for inflation on an investment that takes 50 to 75 years to mature, these lands are being converted to other uses. The timber resource is being lost, forever. As a co-chairman of the Congressional Forestry 2000 Task Force -- an organization representing 150 of our colleagues -- this loss of resource in both the Northwest and the Southeast, and the tax code which encourages it, has for several congresses been our number one target for tax reform. We must remove unreasonable disincentives for critical, very long term investments like growing trees. I note that this position is supported not only by the industry, but also by all of the major environmental organizations, including the Audobon Society and the Sierra Club.

Madam Chairwoman, I know the committee is taking a hard look at these issues. I do believe that your proposal for a 50 percent exclusion addresses the legitimate complaints of these timber growers very effectively.

Capital gains tax policy has been caught in fearsome partisan debate for many years. I believe it is time to move beyond old divisions and I stand ready to work with the Committee to craft job creating legislation that is good for small business, good for investors and good for the federal government.

Thank you.

National Center for Policy Analysis

For Release On Delivery

Statement on

Capital Gains Tax Reform
and
Investment in Small Business

by
Dr. John C. Goodman
President & CEO
National Center for Policy Analysis

Before the
Committee on Small Business
House of Representatives

The Honorable Jan Meyers, Chairman

January 26, 1995

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SUMMARY

Reducing capital gains tax rates and indexing capital gains for inflation would help businesses of all sizes by "unlocking" investments and freeing up the venture capital market . It would make it possible for business owners who retire and sell their businesses to enjoy more of the fruits of their years of labor. It would benefit all income groups, and actually would increase the amount of revenue collected by the government.

People who receive wage income cannot be pushed into a higher tax bracket by the effects of inflation alone, thanks to indexing. But people who receive investment income have no similar protection, and the effective tax rate on their real gains can be extraordinarily high. The purpose of indexing is to ensure that only real gains are taxed.

The present value of an asset is totally determined by the income stream it will generate. Since all of this income will be taxed as it is realized, there is no need to tax the owner of an asset at the time it is bought and sold. The owner who sells the asset will pay this income tax indirectly through a lower sales price for the asset. A capital gains tax, therefore, is not needed in order to insure that all income is taxed at the same rate.

Historically, there has been a negative relationship between capital gains tax rates and capital gains revenues collected by the federal government. Whenever tax rates have been increased, tax revenues have dropped, and vice versa. This history has been repeatedly ignored in Washington.

Capital gains taxes affect investment decisions. In particular, they reduce the amount of capital available for investments with higher risk potential, such as new startups and companies in emerging sectors. As a result, the capital gains tax tends to be a direct tax on entrepreneurship, which is especially injurious to small businesses.

NCPA Senior Fellows Gary and Aldona Robbins predict that the proposed legislation would lower the cost of capital by 5 percent, thereby inducing investors to increase the capital stock by $2.2 trillion by the year 2000. This larger stock of capital would create 721,000 new jobs and increase total GDP cumulatively by almost $1 trillion by the year 2000.

Proposals to cut the capital gains tax rates are labeled as cutting taxes only for the wealthy. However, well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000. Over 73 percent had incomes of less than $75,000.

Moreover, the claim that the tax cut would primarily benefit the wealthy ignores the benefits that flow from new investment. On the average, wage earners receive $12 after tax for every $1 of aftertax income received by investors. Thus, more than 90 percent of the benefits of new investment would flow to wage earners rather than owners of capital.

The Case for a Capital Gains Tax Cut

By John C. Goodman

The 1986 Tax Reform Act increased the maximum tax rate on capital gains income from 20 percent to 28 percent. This 40 percent tax hike has reduced government revenues, discouraged entrepreneurship and caused many investors to hold on to assets they would prefer to sell. The proposal to reduce capital gains tax rates by 50 percent and to index capital gains for inflation, if enacted into law, would benefit both taxpayers and the government.

The tax rate reduction would help businesses of all sizes by "unlocking" investments and freeing up the venture capital market — which provides funds for small business expansion and entrepreneurial activity. It would make it possible for business owners who retire and sell their businesses to enjoy more of the fruits of their years of labor. It would benefit all income groups. It would result in stronger economic growth. And that economic growth, as well as the growth in the realization of capital gains that would result, would increase the amount of revenue collected by the government.

The Case for Indexing. Because tax brackets and the personal exemption are indexed to inflation, people who receive wage income cannot be pushed into a higher tax bracket by the effects of inflation alone. But people who receive investment income have no similar protection. When investors have to pay taxes on gains that merely reflect the effects of inflation, the effective tax rate on their real gains can be extraordinarily high.

Suppose someone invested in common stock in 1970, saw the same appreciation as the Dow Jones Industrial Average, and sold the stock in 1980 with a capital gain of 18.4 percent. Because the price level more than doubled during that period, the nominal gain of 18.4 percent represents a real loss of 44 percent. Despite this loss, the investor would have been assessed a capital gains tax based on the nominal gain. The purpose of indexing is to ensure that only real gains are taxed.

The Case for Lower Tax Rates. The vast majority of assets have value only because they are expected to produce future income. For example, bonds will produce interest income and stocks will produce dividends and retained earnings. As a result, the present value of the asset today is totally determined by the income stream it will generate. Since all of this income will be taxed as it is realized, there is no need to tax the owners of these assets at the time the assets are bought and sold. Further, even without a capital gains tax, sellers of assets indirectly pay taxes on the future income of those assets. For example, a 28 percent income tax reduces the value of the asset by 28 percent, because the asset will generate an income stream that is 28 percent less than it would otherwise be. The owner who sells the asset will pay this income tax indirectly through a lower sales price for the asset.

A capital gains tax, therefore, is not needed in order to insure that all income is taxed at the same rate. Indeed, such a tax is not really a tax on income at all. It is instead a transfer tax. It impedes the efficient transfer of assets from those who value them less to those who value them more, and it makes investments in all income-producing assets less attractive.

Economic Effect: "Unlocking" Investments. When the taxing of inflationary gains is combined with the high capital gains tax rates, the result is a powerful "lock-in" effect. Since selling is taxed and possessing is not, high capital gains taxes encourage investors to hold rather than sell — thereby avoiding the tax indefinitely. Assets that are held until death avoid capital gains taxes altogether.

When investors lock in their assets this way, the capital market becomes inefficient, because the flow of assets to those who value them the most is impeded, and government loses revenue it would have gotten if tax rates had been lower.

Economic Effect: More Revenue for Government. Historically, there has been a negative relationship between capital gains tax rates and capital gains revenues collected by the federal government. Whenever tax rates have been increased, tax revenues have dropped, and vice versa. Investors are highly sensitive to the tax on capital gains. As Figure I illustrates, investors rushed to sell assets in advance of increases in the capital gains tax in 1969 and again in 1987. This led to a bulge in sales in 1968 and again in 1986. After the tax increase, however, asset sales fell. Conversely, cuts in the capital gains tax in 1978 and 1981 led to increased sales, as the lock-in effect abated.

This history has been repeatedly ignored in Washington. In 1986, both the Congressional Budget Office and the Joint Committee on Taxation misled many members of Congress by predicting that the increase in the maximum capital gains tax rate from 20 percent to 28 percent would not deter asset sales and would increase government revenues. Following the selling spree that preceded the tax hike, capital gains income went down, not up.

- Capital gains realizations in 1992 (the latest year for which statistics are available) were $116.5 billion, far lower than the $165.5 billion in 1985.

- After adjusting for inflation, the government collected 13 percent less in capital gains tax revenue in 1992 than it collected in 1985, even though the tax rate was 40 percent higher.

Economic Effect: More Investment. Capital gains taxes affect investment decisions. In particular, they reduce the amount of capital available for investments with higher risk potential, such as new startups and companies in emerging sectors. As a result, the capital gains tax tends to be a direct tax on entrepreneurship, which all economists recognize as essential to growth. This is especially injurious to small businesses, so many of which are started and built by entrepreneurs.

Economic Effect: Economic Growth. All Americans would benefit from the stronger economic growth that would result from lower taxes on capital gains. NCPA Senior Fellows Gary and Aldona Robbins predict that:

- The proposed 50 percent capital gains exclusion and inflation indexing would lower the cost of capital by 5 percent, thereby inducing investors to increase the capital stock by $2.2 trillion by the year 2000.

- This larger stock of capital would create 721,000 new jobs and increase total GDP cumulatively by almost $1 trillion by the year 2000.

Economic Effect: Benefits for All Income Groups. Despite the strong evidence that lower capital gains tax rates buoy the economy, proposals to cut the rates are labeled as cutting taxes only for the wealthy. However, the bulk of taxpayers realizing capital gains are those with middle incomes.

- Well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000.

- Over 73 percent had incomes of less than $75,000.

The small business owner who is not rich and who needs funds to invest in the business usually cannot hold assets until there is a more favorable tax rate. Neither can the small business owner who wants to sell the business and retire for age or health reasons.

Moreover, the claim that the tax cut would primarily benefit the wealthy ignores the benefits that flow from new investment. On the average, wage earners receive $12 after tax for every $1 of aftertax income received by investors. Thus, more than 90 percent of the benefits of new investment would flow to wage earners rather than owners of capital.

Financing the Tax Cut. Expansion of economic activity would increase the overall tax base of the economy by more than enough to compensate for any loss in federal revenue from the tax changes described. Indeed, the indexing feature alone is probably enough to ensure that the proposal increases revenue. Since only new investments would be indexed, most taxpayers would want to realize their existing gains and invest in new inflation-indexed assets.

Small Business SURVIVAL Committee

Testimony Before the United States House of Representatives
Committee on Small Business
Sydney Hoff-Hay, Member of the Board
Small Business Survival Committee
January 26, 1995

Capital Gains Tax Cut Provision in the *Contract with America*

Testimony Before the United States House of Representatives
Committee on Small Business
Sydney Hoff-Hay, Member of the Board
Small Business Survival Committee
January 26, 1995

Capital Gains Tax Cut Provision in the Contract With America

Chairman Meyers, I would like to thank the Small Business Committee for inviting the Small Business Survival Committee to testify before you today on the future of small business in America, and how the new Congress and the Administration can further unleash investment and entrepreneurship in America to sustain long term economic growth and opportunity.

The Small Business Survival Committee (SBSC) is a 40,000-member nonpartisan, nonprofit advocacy organization. Members of SBSC represent a diversity of small businesses and enterprises across America. From home-based businesses, to traditional "mom and pop" businesses, to small manufacturers, to 1995 entrepreneurs and others -- SBSC's membership is as diverse as the small business sector itself.

If there is anything in America that represents attainment of the American Dream, it is owning your own business. Unfortunately, most small business owners and entrepreneurs cite their most daunting day-to-day obstacles of running their business as government-imposed -- namely, taxes and regulations. Traditional business-related hurdles relating to sales, marketing, motivating employees, or topics that also require tremendous time and resources from the owner seem to have taken a back seat to the increased workload and costs imposed by the government. Government has become the main obstacle to small business prosperity, and not surprisingly more and more Americans do not view their government as protector of our great free enterprise system.

Beyond the twin burdens of taxes and regulations which are slowly strangling productive entrepreneurial activity, the United States non-indexed capital gains tax creates another impediment for entrepreneurs wishing to start-up or expand an enterprise. The federal government needs to encourage, not punish, private-sector investment.

Eliminating Capital Gains Taxes:
Lifeblood for an Entrepreneurial Economy

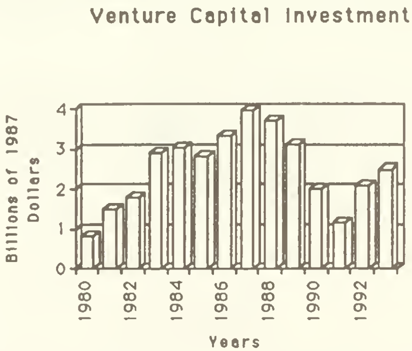
Most entrepreneurs seeking to start up or expand an enterprise will tell you of a major obstacle -- raising capital. Encouragement for private-sector investment in small business needs to be enhanced. *While SBSC fully supports eliminating the capital gains tax, the Contract With America proposal which, combined with indexation, reduces the top capital gains tax rate to 19.8 percent, could be the most pro-growth step taken by the new Congress.*

There is no more important economic task than investing both sweat and capital in new ideas, innovations, and enterprises. Yet the risky nature of such ventures scares off bank lending officers. Therefore, venture capital, whether raised from one's family and friends or from professional investors, remains a critical source of funding for entrepreneurial enterprises.

The capital gains tax is a direct levy on investment and entrepreneurship. Investment and entrepreneurship are the lifeblood of a vibrant economy and remain the engines of economic growth and job creation. The current, non-indexed federal tax rate of 28 percent on capital gains remains a formidable obstacle to economic expansion, especially considering the risky nature of investing, and starting and operating a business.

The potential benefits of reducing and indexing the capital gains tax are clear. Venture capital investment was on the rise as the U.S. capital gains tax rate declined up to 1986; followed by a dramatic downturn as the rate was hiked 40 percent in 1987, from 20 percent to 28 percent. Since the 1986 Tax Reform Act raised the capital gains tax rate by 40 percent, venture capital investment has nose-dived, and federal capital gains tax revenues have consistently run well below government expectations. In fact, according to CATO economist Steve Moore, 1991 revenue realizations (most recent available) equaled $108 billion versus a late-1980's Congressional Budget Office prediction of $269 billion and a Joint Economic Committee prediction of $285 billion.

The Small Business Survival Committee



Source: Venture Economics. Calculations to real dollars by author

How the U.S. Stacks Up Internationally -- In the expanding global economy, it is imperative that the United States be competitive with other nation's on the capital gains front -- the U.S. needs to be a haven and magnet for capital. The current non-indexed capital gains tax rate is not competitive internationally. Belgium, Germany, Hong Kong the Netherlands all have a zero rate on long-term capital gains. Canada, France, Italy and Sweden have lower capital gains than the U.S., with Japan's rate equalling 1 percent of sales price or 20 percent of net capital gain. Even the two nation's with higher nominal rates than the United States -- Australia and the United Kingdom -- allow for capital gains to be indexed for inflation. Hence, the U.S. *real* capital gains tax rate often will exceed the rate in Australia and the U.K., depending on U.S. inflation.

From a capital gains perspective, these other nations offer a more conducive and dynamic environment for investment and entrepreneurship. In order to stay on par with our competitors, the United States needs to encourage risk-taking, entrepreneurship and investment -- not punish these activities.

Given the critical and risky nature of investment and entrepreneurship, and the importance of maintaining a competitive environment in a global economy, capital gains should be excluded altogether. A zero capital gains tax rate would ensure that entrepreneurial risk taking, so crucial to economic growth, would not be impeded by the U.S. federal tax code. The steps taken in the Contract With America to reduce and index the capital gains tax rate is a good start.

Indexation -- The nominal rate of federal taxation is 28 percent. However, when inflation is factored into the capital gains equation the *real* capital gains tax rate rises substantially.

The lack of indexation creates additional disincentives for investment and entrepreneurship, restraining small-business growth and job creation. In fact, some individuals can wind up paying taxes on real capital losses. That is, after factoring inflation into the equation, a nominal profit on a transaction can turn out to be a real loss, yet the investor still pays taxes on the nominal gains. *Real rates* of capital gains taxation represent severe impediments to keeping America's economy vibrant and growing.

Figure 1 offers an example of how inflation can impact capital gains tax rates. Listed are the real capital gains tax rates from 1977 through 1993 on three-year investments yielding a total nominal return of 30 percent. (It is assumed that the investment is closed out at the end of the stated year, for example, the 1985 real capital gains tax rate to an investment made at the beginning of 1983 and sold at the end of 1985.)

Figure 1

The Small Business Survival Committee

Figure 1: Real Capital Gains Tax Rate on Three-Year Investments Yielding a Nominal Return of 30 Percent

Year	Nominal Capital Gains Tax Rate*	Real Capital Gains Tax Rate
1977	35%	191%
1978	28	114
1979	28	175
1980	28	494
1981	20	Tax on a Real Loss
1982	20	286
1983	20	71
1984	20	41
1985	20	34
1986	20	54
1987	28	42
1988	33	48
1989	28	47
1990	28	50
1991	28	50
1992	28	45
1993	28	40

* Source: The American Council for Capital Formation

A 28 percent capital gains tax rate acts as a considerable disincentive to investment, while *real* rates ranging from 40 percent to 494 percent to even paying taxes on a real capital loss, amount to economic suicide. Indexation would eliminate inflation as a factor in capital gains determination -- equalizing state and real capital gains tax rates. The lower real rate would reduce uncertainty, and generate investment, economic growth, and job creation.

Who Benefits? Opponents who engage in class warfare rhetoric to dismiss lowering and eliminating capital gains tax rates are employing tactics which the American public, quite frankly, is sick of hearing. "Soak-the-rich" schemes and "fair-share" arguments will continue to backfire on those who feel they can defeat the issue on these divisive grounds. Not only does reducing/eliminating the capital gains tax make sense, but capital gains tend to be spread across a wider income spectrum than many believe. Based on 1992 federal income tax returns, 56 percent of returns claiming capital gains were from incomes of $50,000 or less, including the capital gain. Fully, 83 percent of returns with capital gains were from total incomes of less than $100,000, including the gain.

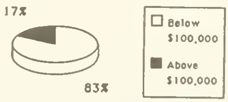
The Small Business Survival Committee

Figure 4: Income Tax Returns With Capital Gains By Total Income Level, 1992

Source US Internal Revenue Service, Individual Income Tax Returns, Preliminary Data, 1992

The Small Business Survival Committee

Figure 5: Income Tax Returns With Capital Gains By Total Income Level, 1992



Source US Internal Revenue Service Individual Income Tax Returns, Preliminary Data 1992

Wages and Interest vs. Capital Gains -- In addition to false assumptions about the identification of capital gains just with the wealthy, opponents of cutting or eliminating capital gains taxes often argue that no reason exists for differing tax treatments between capital gains and, for example, wage or interest income.

In fact, there is a distinct difference between wage or even interest income and capital gains -- risk. Capital gains come from growth and appreciation of investments, which tend to carry greater risks than those associated with earning wages or even interest. In particular, investments in small, entrepreneurial ventures carry significant risk. As already noted, high-risk ventures must at least present the opportunity for rewards.

Conclusion on Capital Gains -- Small business is the engine of economic growth and job creation. In order to undertake and/or expand a small business, one needs capital. Without adequate capital, new ideas and businesses either never make it to the marketplace or they die a premature death. With such deaths go products, services and jobs. By taking the first step in the *Contract With America*, and indexing and reducing the capital gains tax rate, Congress and the Administration would greatly strengthen incentives for investment and entrepreneurship -- boosting economic growth and activity.

History shows that class warfare does not make for good economic policy. In fact, during the 1980's, while tax rates declined, upper-income individuals paid a greater share of total income taxes, as the benefits of tax shelters declined and the rewards for working, saving and investment rose. In this environment, from 1980 to 1989, 18 million jobs were created.

The 1986 Tax Reform Act made positive strides by reducing personal and corporate tax rates, but went awry by trying to "pay" for these reductions with an increase in the capital gains tax rate. Indeed, the economy paid a price for this capital gains tax hike in the form of reduced venture capital investment.

The time has come to fully unleash our entrepreneurial capacity by first reducing and indexing, and then eliminating the capital gains tax.

BIOTECHNOLOGY INDUSTRY ORGANIZATION

**TESTIMONY OF HENRY ("PETE") LINSERT
CHAIRMAN AND CEO,
MARTEK BIOSCIENCES CORP
TESTIFYING ON BEHALF OF THE
BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)**

My name is Henry ("Pete") Linsert and I am Chairman and CEO of Martek Biosciences Corporation of Columbia, Maryland.

I am testifying today on behalf of the Biotechnology Industry Organization (BIO). My testimony will outline the capital gains tax incentive for entrepreneurs and emerging companies endorsed by BIO. BIO represents 570 biotechnology companies and others involved in every sector of the biotechnology industry -- biomedical, bioag, bioremediation and bioenzymes.

Summary of Tax Policy Recommendation

As all entrepreneurs must do, let me start with the bottom-line: BIO supports enactment of both an across-the-board capital gains incentive and a second tier incentive targeted at direct investments in the stock of emerging companies.

Let me now provide some background on Martek and the biotechnology industry and on BIO two-tiered capital gains proposal.

Background on Martek

Martek Biosciences Corporation has primarily conducted R&D since its beginning in 1985. To support this effort, Martek has raised over $25 million in equity capital and obtained approximately $6 million from 40 small business innovation grants, primarily from NIH. Starting with 5 scientists in 1985, Martek now employs 70 people directly, primarily life sciences scientists; and indirectly, numerous others through subcontracts for clinical research, as well as suppliers of equipment and services.

Martek develops products for improved health and nutrition from microalgae. Microalgae are a separate kingdom of organisms in nature and are the "rain forests" of the world's oceans, lakes and rivers. They do many biochemical things differently than other organisms, and thus are a great source of unusual compounds of potential value to humans. Martek's roots go back 10-15 years to technology developed by NASA and Martin Marietta. Martek is 10 years old this year and has been conducting research and development on these unusual creatures since its inception. Its lengthy R&D is finally beginning to pay off in the introduction of 4 product families.

The first one is based on unusual fatty acids that Microalgae make that strangely enough, are found concentrated in the gray matter of human brains, the retina, heart and nervous tissue, basically wherever there is electrical activity in the body. Humans have a great deal of brain development after birth, and this requires dietary supplementation for fatty acids essential for such development. These fatty acids are provided in human breast milk, but not found in infant formula. Over the last 5 years there has been a growing and increasingly convincing body of evidence that indicates that the lack of these fatty acids in

infant formula can lead to long-term IQ deficiencies and behavioral problems. This not only applies to infants born normally on time, but is true especially for low birth weight and preterm infants, which make up approximately 250,000 infants born annually in the US alone. As a result of its lengthy R&D, Martek has developed patentable manufacturing technology that will provide these fatty acids in mass, economic quantities to support infants and their mothers throughout the world. Martek's technology will use fermentable microalgae that will turn low cost US corn and soybeans into high value-added vegetable oils rich in these fatty acids for blending into infant formula, foods and dietary supplements for export around the world.

Other contributions the Martek expects to make over the coming years are (1) new enabling technology that could lead to a much more efficient way of developing new pharmaceuticals, (2) a new, low cost way of diagnosing gastrointestinal problems using human breath rather than the current expensive and invasive procedures using tubes inserted through the throat into the stomach or slivers of liver taken out with large needles, and (3) a new generation of antibiotics, effective against some of the most antibiotic resistant pathogens.

Martek's products are a tiny portion of what biotechnology is bringing to humans in the near-term future. Its an exciting time at Martek and an exciting time for the biotechnology industry.

Capital Formation is the Issue

The issue for entrepreneurs in the biotechnology industry is capital formation.

Bringing a biotech drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the Food and Drug Administration can take 10-12 years, and this process can cost anywhere from $150 to $359 million. Both the length and cost of this process are a tremendous impediment for small biotechnology companies to be successful bringing a product to the market.

After raising enormous amounts of capital, and conducting cutting-edge research, a company can find that its lead product is not approved by the Food and Drug Administration. We work in an industry which cannot sell and market its products without government approval and the requirements for approval are onerous.

The biotechnology industry consists of over 1,300 companies, of which 265 are publicly traded. The biotechnology industry is one of the most capital intensive industries in the history of civilian manufacturing. R&D accounted for 43% of total costs and expenses incurred by public biotechnology companies in 1994 and expenditures averaged $68,000 per employee. This compares with expenditures of $7,500 per employee for all manufacturing companies.

Total sales for the biotech industry were $7.7 billion in 1994. However, since the industry spends such a large percentage of it's capital on research and development, the industry experienced a net loss of $4.1 billion in 1994, and has lost approximately $14 billion over the last 5 years.

The industry is in-the-middle of one of the worst financial crisis in its history. A major contributing factor to this crisis was the Administration's assault on drug prices. The AMEX biotechnology stock index has declined by 50% since January, 1993.

Ernst & Young reports that there are currently only 27 biotechnology therapeutics and vaccines on the market, with 270 in human development, and over 2,000 in early research stages. Forming capital to fund research and coping with an economic crisis in its capital markets are the keys to the ability of the biotechnology industry to maintain its current competitive dominance in world markets.

<u>Tax Code Skewed Against Entrepreneurs</u>

It should not be surprising that the tax code does not recognize the special strengths and needs of the biotechnology industry. The tax code is old and relatively inflexible and it reflects the values of our economy as it was in the past. The problems entrepreneurs have with the tax code is similar to the problems they have with agency regulations. They may be well intentioned, but they do not work in the real world. We urge this Committee to look at the tax code much as are other committees which are developing a regulatory relief program.

The Congress should ensure that our tax code recognizes the needs and reality of today's entrepreneurs. This mostly requires that existing incentives be made permanent and/or restructured -- the targeted capital gains incentive, the R and E Credit, amendments to Section 382, and the Orphan Drug Credit. With the exception of enactment of an across-the-board capital gains incentive, all of these proposals are for amendments to current law, not the enactment of new incentives. That is what is needed to ensure that our tax code does not discriminate against or ignore America's most entrepreneurial industry

Let me now provide more details on our two-tiered capital gains proposal.

Capital Gains Tax Incentives

BIO supports enactment of both an across-the-board capital gains incentive and a second tier incentive targeted at direct investments in the stock of emerging companies.

Biotechnology companies depend on direct equity investments to fund research. With so few products approved and so little in sales as compared to expenses, equity investments are the principal source of funding for research. Investors are asked to take tremendous risk with these investments; a risk that the firm's science will be successful, that the products will be approved for sale by government regulatory agencies, and that the market sales will produce profits commensurate with the risk. This risk must be sustained over the 10-12 year period which is involved in biopharmaceutical drug development.

Capital gains tax incentives are important in encouraging investors, including venture capital investors, to purchase the stock of biotechnology companies, to put their capital at risk with a long-term, speculative investment. Tax policy is one of the only variables which the government can influence with respect to the risk involved with these investments.

BIO proposes a two tier capital gains incentive. This proposal originated with Senator Robert Packwood who proposed a combined across-the-board capital gains tax cut and targeted venture capital gains incentive during the crucial 1989 capital gains debate in the Senate. The 1989 debate was the critical capital gains debate during the Bush Presidency because this Committee and the House had adopted a capital gains incentive in its version of the Budget Reconciliation bill -- the Jenkins amendment. Senator Packwood sought to include a gains tax reduction in the Senate bill to ensure that a gains incentive would emerge from the conference. The proposal he advanced was a two-tier incentive which BIO here

recommends.

The Packwood capital gains proposal included a sliding scale capital gains tax reduction depending on the length of time the capital asset had been held. It proposed that "qualified venture capital stock" held for four or five years receive a gains tax reduction which was roughly twice as great as the incentive for non-venture capital stock.[1] The definition of "venture capital stock" stock in his proposal was based on a capital gains bill proposed by Senator Dale Bumpers and Congressman Bob Matsui, a bill which is discussed below. Senator Packwood said, "The amendment includes an even more favorable capital gains rate for new venture capital investments. Frankly, this is an idea we picked up from Senator Bumpers." (November 14, 1989, Congressional Record) The Packwood two-tier gains proposal was blocked in the Senate and did not become law. This same venture capital incentive was later endorsed by President Bush during the 1992 Presidential campaign. President Bush had long endorsed an across-the-board gains tax reduction and in a September 23, 1992, announcement he also endorsed the targeted capital gains proposal. (September 23, 1992, White House Small Business Plan).

Governor Clinton and Senator Gore also endorsed a targeted capital gains incentive during their 1992 campaign. (September 30, 1992, Small Business Plan) A reprint from the October 1, 1992 BNA report on the Bush and Clinton endorsements of the targeted capital

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[1] The exclusion of gains from tax in the Packwood amendment to the reconciliation bill for non-venture capital stock held for four years was set at 20% and for five years was set at 25%. The exclusion for venture capital stock held for four or five years was set at 40%. The exclusion for non-venture capital stock held for six years was set at 30% and for seven years was set at 35%. The exclusion for venture capital stock held for six or seven years was set at 50%.

gains incentive is printed as an appendix to my testimony.

BIO, and its predecessor organization, the Industrial Biotechnology Association (IBA), have long endorsed an across-the-board reduction in capital gains taxes. With the deadlock in the Congress on an across-the-board capital gains tax rate reduction in 1989, and the failure to include it in the Bush-Congressional budget deal of 1990, a number of trade associations representing high technology firms -- including IBA, the National Federation of Independent Business, National Venture Capital Association, and American Electronics Association -- endorsed a targeted capital gains incentive. They relied, in part, on the endorsement of this concept by Senator Packwood and were encouraged by the endorsement of it by President Bush and the Clinton/Gore campaign.

These associations continued to endorse an across-the-board gains tax reduction, but with that proposal effectively stymied in the Senate, they sought enactment of an incentive which both Republicans and Democrats could support.

The targeted incentive which Senator Packwood, President Bush and the Clinton/Gore Campaign endorsed provided for a 50% reduction in capital gains taxes for direct investments in the stock (stock bought directly from a company, not secondary trading of the stock after it is issued) of a small business (defined as having $100 million or less in aggregate capitalization) if the investment is held for at least five years. The incentive applied to investments by individual and corporate taxpayers and applied only to investments made after the effective date of the law (not to the sale of investments previously acquired).

Unfortunately, after their election President Clinton and Vice President Gore proposed drastic limitations on the targeted capital gains incentive during the Fiscal 1994 budget

debate, incentives which effectively gutted the incentive. These limitations included the following six ways:

1. lowering the capitalization limit to $50 million;
2. not indexing this figure for inflation;
3. applying the incentive only to individual taxpayers;
4. limiting the per taxpayer benefits to 10 times the basis of the investment or $10 million (whichever is greater);
5. exempting only half of the excluded gains from the Alternative Minimum Tax (AMT); and
6. substantially modifying the definitions dealing with "working capital" requirements.

The reduction in the number of companies which qualify (the capitalization ceiling) is particularly critical to the biotechnology industry, which needs to raise huge amounts of capital to fund research. Corporate taxpayers are major investors in small companies, so it is important to cover them with this incentive. The per taxpayer limits reduces the prospects for an investor generating sufficient gains on one investment to cover losses of capital with many others. The AMT provision is important as the AMT recaptures the gains tax benefits and for many taxpayers cancels out any incentive to make the investments. And, the working capital rules are completely unworkable.

This incentive, with the Clinton-Gore Administration proposed limitations, was included in the 1993 Budget Reconciliation bill and became law. An informal survey of our members finds that this incentive has not been a factor in forming capital for entrepreneurs and emerging companies.

BIO is delighted that the Congress is poised to finally enact an across-the-board capital gains tax reduction for investments in any "capital asset" (many types of investments) if it is held for one or more years. The incentive would apply to the sale of assets acquired prior to the date of enactment of the incentive. The Congress appears ready also to endorse

indexing the basis of the capital assets for inflation. BIO strongly supports both of these proposals and urges the Congress to enact them into law.

BIO continues to support a targeted gains incentive which supplements this across-the-board incentive. This targeted incentive would ensure that there exists a distinct and more powerful incentive for high-risk, long-term investments in entrepreneurial firms and emerging companies. We believe there is a bipartisan consensus on the merits in favor of a targeted gains incentive.

The second tier incentive would build on the false-start of the 1993 incentive in the following eight ways:

1. Increase the capitalization ceiling to at least $100 million, or eliminate it altogether, and index any capitalization ceiling for inflation
2. Apply incentive to corporate taxpayers
3. Provide a gains exclusion which is greater than that which is provided for all other capital assets (e.g. if regular capital gains exclusion is 50%, exclusion for targeted incentive should be 75% or 100%)
4. Eliminate the "10 times or $10 million" per taxpayer limitation
5. Exempt all of the excluded gains from the alternative minimum tax
6. Fix the "working capital" rules
7. Provide for a deferral of gains taxes (a rollover provision) for those who reinvest proceeds from sale of any capital asset into stock covered by this incentive (set time period in which rollover must occur) and
8. Apply the incentive to investments which were made before effective date for 1993 law.

BIO endorses this targeted capital gains incentive as a second tier incentive to be adopted in combination with an across-the-board incentive. The targeted incentive would ensure that the tax code acknowledges the exceptional risk which is involved with investments in biotechnology and other emerging industries. BIO does not propose this incentive as a substitute for the Contract for America across-the-board incentive, which it

strongly supports, and would oppose it if it is deemed inconsistent with adoption of the across-the-board incentive.

Summary of Other Tax Policy Recommendations

Let me just summarize BIO's three other tax policy recommendations. BIO supports the following:

1. making the Research and Experimentation Credit (R and E Credit) permanent or extending it for 18 months and restructuring the R and E Credit by reducing the fixed base from 16% to 8% and raising or eliminating 50% cap; and

2. making the Orphan Drug credit permanent or extending it for 24 months and restructuring the Orphan Drug credit so that it can be carried forward by companies with no tax liability with respect to which to claim the credit.

3. removing the disincentive for research and the penalties on emerging companies found in Section 382 of the Internal Revenue Code (Net operating loss change of ownership);

We hope to work with the committee on these issues as well.

Conclusion

The biotechnology industry is a major success story in the making in America. It is the more entrepreneurial industry in terms of research intensity and capital formation. It thrives on innovation and long term risk-taking. We should ensure that our tax code recognizes its unique characteristics and needs.

Thank you for the opportunity to testify here today.

Campaign '92

CLINTON JOINS BUSH IN ENDORSING BUMPERS CAPITAL GAINS AMENDMENT

Democratic presidential candidate Gov. Bill Clinton Sept. 30 praised a provision in the Senate tax bill (HR 11) to reduce capital gains taxes for venture capital investments, joining President Bush in support of the provision sponsored by Sen. Dale Bumpers (D-Ark).

"This is unbelievable that Bumpers has brought Bush and Clinton together on the most contentious tax issue of our time, the capital gains issue," said a Senate staff member working on the legislation.

"It is now very hard for [Finance Committee Chairman Lloyd] Bentson (D-Texas) or [Ways and Means Committee Chairman Dan] Rostenkowski (D-Ill) not to include the provision in the conference committee bill, because that would be a slap at Clinton," the aide continued. "It is now very hard for Bush to veto a bill with this in it, because Clinton is in a position to flank Bush on the right."

Many other complications could tie up the tax bill, conceded the aide while still arguing for the significance of Clinton's endorsement. "We used to be a dingy in a big sea, now we are an ocean liner in a big sea," the aide said.

Clinton's comments in Clinton, Md., came as he added further details to his proposals aimed at small business—a constituency getting attention from both candidates. President Bush's endorsement of Bumper's amendment, without mentioning Bumpers, was made Sept. 23 when he fleshed out his small business platform (186 DTR G-9, 9/24/92). That announcement followed by several days Clinton's "technology policy" initiative.

Clinton's endorsement was more of an evolutionary shift than a radical change, according to those familiar with the decision. Clinton was already on the record in support of providing a 50 percent capital gains exclusion for gains from new investments in small business stock held at least five years.

However, Clinton had not previously supported the expanded tax break contained in Bumper's "seed capital amendment," as added Sept. 25 to the Senate tax bill (188 DTR G-6, 9/28/91; 189 DTR L-33, 9/29/92).

Sliding-Scale Exclusion

The amendment applies to the gains to individual investors from investments in companies with aggregate capitalization of under $5 million and provides a sliding scale making possible an exclusion of 50 percent after five years and up to 100 percent for stock held for 10 years or more. The excluded gains are not included in the alternative minimum tax. The amendment's estimated cost of $336 million over five years is financed by placing a $19,000 limit on the moving expenses deduction.

President Bush's Sept. 23 support for the Bumpers amendment followed his March opposition to an earlier Bumpers proposal, the one supported by Clinton, which would have provided a 50 percent exclusion for investment held for five years in companies capitalized up to $100 million. In a March 10 statement, Bush criticized the provision, which was contained in another tax bill (HR 4210) as "far too narrowly targeted." He had endorsed applying such an incentive in the context of enterprise zones.

Also on Sept 23, Bush backed additional tax breaks for small business, including an increase in the current equipment expensing limit from $10,000 to $25,000, and supported permitting the immediate write-off of up to $2,500 of the front-end costs of starting up a new business.

Clinton characterized the Bumpers amendment as an alternative to the Bush proposal to more drastically cut capital gains taxes, which the president continues to support. "No more across-the-board capital gains cuts for turning money, but real incentives to create jobs in the American economy," Clinton said.

Saying that "the first thing we need to do is increase access to money and credit for small business," Clinton cited his past support for "a new enterprise tax credit that would allow a 50 percent cut in the income tax for any gain coming after someone holds a new business for five years," and went on to mention the larger Bumpers' proposal. Although Clinton did not explicitly endorse the measure, that was his intention, aides said.

A number of other tax proposals are contained in Clinton's program to help small business, according to a Clinton campaign fact sheet, including "a targeted investment tax credit, making permanent the research and development tax credit, and creating comprehensive enterprise zones." Clinton said the current tax system makes no distinction between buying a Maserati and investing in new equipment, and the fact sheet indicated Clinton will "explore allowing a longer tax carryforward for net operating losses." and "explore allowing start-up small businesses a longer carryforward period for the R&D tax credit." The fact sheet stated that under Clinton's health care proposal requiring employers to provide health care coverage to their employees, tax credits would be incorporated to help small businesses.

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BIOTECHNOLOGY INDUSTRY ORGANIZATION

PROPOSED AMENDMENTS TO 1993 TARGETED CAPITAL GAINS PROVISION

In addition to enacting an across-the-board capital gains incentive, the following amendments need to be adopted to the 1993 targeted capital gains provision:

1. 1993 targeted capital gains incentive as enacted into law

a. Applies only to new investments made after effective date of law

b. Applies only to purchases of common and preferred stock

c. Applies only to stock issued by the company; not to sale of stock on secondary markets

d. Stock must be issued by company with $50 million or less in capitalization and this ceiling is not indexed for inflation

e. Stock must be held for at least five years

d. Applies only to individual, not corporate, taxpayers

f. Taxpayer is taxed on half of gain (50% exclusion)

g. Taxpayer's benefits limited to "10 times basis in stock or $10 million, whichever is greater"

h. 50% of excluded gains covered by alternative minimum tax

i. "Working capital rules" contain onerous requirements

2. 1993 targeted gains incentive needs to be amended in the following ways

a. Increase the capitalization ceiling to at least $100 million, or eliminate it altogether, and index any capitalization ceiling for inflation

b. Apply incentive to corporate taxpayers

c. Provide a gains exclusion which is greater than that which is provided for all other capital assets (e.g. if regular capital gains exclusion is 50%, exclusion for targeted incentive should be 75% or 100%)

d. Eliminate the "10 times or $10 million" per taxpayer limitation

e. Exempt all of the excluded gains from the alternative minimum tax

f. Fix the "working capital" rules

g. Provide for a deferral of gains taxes (a rollover provision) for those who reinvest proceeds from sale of any capital asset into stock covered by the targeted gains incentive

h. Apply the incentive to investments which were made before effective date for 1993 law

Statement of

Paul L. Pryde, Jr

PRYDE AND COMPANY

before the

HOUSE COMMITTEE ON SMALL BUSINESS

January 26, 1995

Statement of
Paul L. Pryde, Jr
PRYDE AND COMPANY
before the
House Committee on Small Business

January 26, 1995

Good morning, Madame Chairman. My name is Paul Pryde. I am President of Pryde and Company, a consulting firm specializing in capital and business formation issues. Having devoted much of my professional career to the capital access problems of small and minority firms, I am delighted to appear before you to express my views on the role of government policy--tax policy in particular--in encouraging investment in small business.

The important role played by young, small firms in generating new jobs has been widely documented. What may not be as well known, however, is the critical contribution made by minority firms in creating jobs for African-American and Hispanic citizens. In his recent book, Banking on Black Business, Timothy Bates, perhaps the nation's leading authority on minority entrepreneurship, found that firms owned by members of minority groups have greater propensity to hire minority workers than similar white firms. This should not be surprising. After all, most small business owners--black or white--find their employees through informal networks of friends and business associates.
As a result, African-Americans entrepreneurs, through their networks, tend to hire black workers; white firms through theirs, are likely to assemble workforces that are predominantly white.

In any event, Bates' findings make one conclusion inescapable. If one wants to reduce Hispanic or African-American joblessness, increasing the formation and growth rate of firms owned by African-American and Hispanic entrepreneurs has to be an important part of the strategy. In addition to revealing the previously unresearched link between minority employment and minority entrepreneurship, Bates research confirmed what other students of small and minority

business have always found: that persistent capital access problems continue to inhibit the formation and expansion of the types of firms most responsible for job creation. One result is that the nation's distressingly high levels of inner-city and minority unemployment are even higher than they otherwise would be.

In considering new tax or other legislation to encourage increased investment in small and minority firms, it is important to keep three current policy imperatives in mind.

- We should minimize public cost. Today's climate demands that we spend (or invest) the public's money wisely. Thus, any new policy should cost as little as possible in achieving the intended result. Where possible, public cost should be shifted to private parties.

- We must target help precisely. Capital markets generally work well. Thus, it is important that policy changes be aimed in a rifle-shot manner at the market problem to be solved. Failing to do this will cause market distortions worse than the original difficulty. The cure will be worse than the disease.

- We should expand economic equity. Well-considered changes in tax policy can greatly improve economic efficiency. However, it is important that more efficiency not be achieved at the cost of widened economic disparity. To put it bluntly, tax policy should not favor the "haves" over the "have nots"

With these standards in mind, I have offer four suggestions for making capital market more efficient and fairer when it comes to small business. The first two are designed to overcome the problems small and minority firms confront in securing private equity. The second two are addressed to the difficulty these firms experience in raising debt.

1. Strengthen Sections 1044 and 1202 of the Internal Revenue Code. In 1993, after years of debate, Congress enacted two capital gain tax cuts aimed at helping small and minority firms. Section 1044, the capital gains rollover provision allows any corporate or

individual taxpayer who sells stock in a publicly-traded company to avoid capital gains tax by investing the proceeds in a Specialized Small Business Investment Company (SSBIC). An SSBIC is an SBA-regulated venture capital company organized for the purpose of financing minority-owned firms. Section 1202, the capital gains exclusion, provides that 50% of the gain from the sale of newly issued small business stock is excludable from income tax provided the stock is held for five years. Only companies with less than $50 million in gross assets and earning most of their income principally from "active" sources --i.e. other than interest, royalties and the like -- are eligible. SSBIC's, however, are expressly excluded from this limitation.

Both Sections 1044 and 1202 are targeted to what members of both parties apparently agreed was a persistent capital market problem, the inability of small, young firms to raise equity in the private capital markets. Instead of cutting capital gains taxes across the board--a step that is likely to be both costly and market-distorting--why not perfect these two provisions. Specifically, the following amendments to the current provisions are in order.

- Section 1044 now requires that the purchase of SSBIC stock must be made within 60 days from the date that assets eligible for 1044 treatment are sold. This is an unreasonably short interval and should be lengthened to at least 180 days.

- Section 1044 also imposes annual and cumulative limitations on the use of the rollover provision. For individual taxpayers the annual and lifetime ceilings are $50,000 and $500,000 respectively. For corporations the ceilings are $250,000 and $1 million. The annual limit should be eliminated with taxpayers subject only to cumulative limitations on rollover transactions.

- Section 1202 expressly exempts SSBICs from the requirement that issuers of eligible stock use most of their assets to engage in active rather than passive activities. However, the exemption does not apply to certain regulated investment

companies and partnerships even though they may be organized for, and engaged in, precisely the same activities as exempt SSBICs. The SSBIC exemption available under Section 1202 should be made available to all investment companies organized for the purpose of investing in eligible minority firms. Substance should prevail over form.

2. Make equity investments in eligible Empowerment Zone or Enterprise Community firms fully tax-deductible. Many small firms receive their early seed capital from informal sources-- friends, family members and business associates. One way to encourage individual investors to provide risk capital to promising, young firms would be to make equity investments in these firms fully tax deductible. To reduce the cost (and possible abuse) of this provision, it could be limited to businesses located in designated Empowerment Zones and Enterprise Communities. That is, a taxpayer who invested $10,000 in a new assembly plant in an eligible area would be entitled to a $10,000 tax deduction in that year. Upon sale of the asset, the taxpayer could be taxed (or not) at the normal capital gains rate. This provision was included in many early Enterprise Zone bills and deserves a trial under the current program. It could be paid for by reducing the value of employee wage credits available to Empowerment Zone firms.

Beyond their difficulties in raising equity, most small firms also experience in obtaining financing in the private debt markets. Accordingly, I offer two, low-cost suggestions for increasing the availability of credit to job-creating small and minority companies.

1. Restore tax-exempt treatment to small issue IDB's. The 1986 tax act restricted the issuance of tax-exempt debt to manufacturing firms. Extending tax-exempt treatment to all bonds issued on behalf of eligible small firms would increase the availability of affordable financing to job-creating small businesses. This recommendation already has the support of a number of mayors and several members of the Senate

2. <u>Permit FNMA and Freddie Mac to hold a small percentage of their assets in the form of commercial and industrial loans.</u>

   One of the reasons that small firms have more trouble than homeowners in obtaining loans is that a large secondary market in small business debt does not exist. Allowing FNMA and Freddie Mac to hold, say one percent, of their assets in loans to small business could create a significant market for small business-related securities thus encouraging both new small business loans and lenders. A ceiling on non-residential assets held by the two housing GSEs would prevent any distortions in the fundamental mission of the two organizations. (Inasmuch as many small business loans are collateralized by the owner's personal residence, these loans could be considered, in the broad sense, "housing-related assets").

   At the very least, FNMA and Freddie Mac should be asked to examine the impact of this proposed shift in policy on the availability and cost of both mortgage and small business credit.

Madame Chairman, finding ways to make capital markets work for small businesses and minority entrepreneurs is vital to America's social health and to its economic vitality. However, we need not invent entirely new ideas. Many of the policies and mechanisms required to increase the flow of private debt and equity to small firms are already in place or have been previously agreed on. By building on existing policy and past consensus, we can solve the capital access problems of small and minority firms with a minimum of public cost and debate.

Testimony before the House Committee on Small Business

Jan Meyers, Chairman

By Alan P. Sklar

January 26, 1995

Madam Chair and members of the committee, thank you for inviting me to testify today.

My name is Alan Sklar. I come before you representing myself and other business owners. I am the managing partner of Gleeson, Sklar, Sawyers & Cumpata LLP, a 65 person CPA firm with two offices in the Chicagoland area. Therefore, I come before you as a business owner with responsibility for maintaining and growing a business. I am also a delegate to the White House Conference on Small Business in 1995 and I was a delegate in 1986. I am Chair of the Illinois Delegation's Capital Formation Committee and a member of the Taxation Committee. I'm also President of Small Business United of Illinois, a 200 member organization representing interests of small businesses in Illinois. So I come before you representing other small businesses, my small business, and seeing the impact of tax law on clients of our firm.

Capital Gains

Members of Congress propose cutting the individual capital gains rate from a maximum of 28% to 19.8% and indexing future gains against inflation so that you would pay tax only on your real gains. I experienced in the past two times when the capital gains were lowered that many of our clients sold investments that they were holding onto because of the high income tax rates. In effect, it freed up money from frozen assets and made it available for other types

of investment. I hope that with proper incentives some of this money will go into small business. Capital gains are also a form of double taxation because corporations' profits are already taxed once. By lowering the rate on capital gains, it at least cuts down the impact of this double taxation. But the biggest reason I'm in favor of reducing the capital gains rate is that it will serve as an incentive for people to invest in small businesses. One of the biggest needs for small business is capital. Most small businesses are under capitalized. I believe by cutting the capital gains rate, many more people will be willing to invest in small businesses. If this provision isn't passed then I favor the expansion of the more targeted capital gains tax reduction included in the Omnibus Budget Reconciliation Act of 1993.

Expansion of The Present 50% Exclusion For Investment In Qualified Small Business Stock

At the present time if a person makes an investment in a qualified small business and holds the stock for more than five years, they are eligible to exclude 50% of the gain. A qualified small business is one defined as "a domestic C corporation." This provision has limited tax impact for investments in small businesses. Many small businesses are organized as S corporations and investments in S corporations are not eligible for this 50% exclusion. I believe it would be very beneficial as an incentive for investment in small business to expand the definition of a qualified small business to include S corporations. By including S corporations most minority owned, women owned, and small businesses would qualify for this exclusion. I believe cutting capital gains rates is a cost effective way to spur investment and economic growth but I don't think it is enough. We need to become more creative to create incentives.

Another Method For Utilizing The Tax Code As An Incentive For Investment In Small Business

As I stated earlier, one of the most pressing problems confronting small business is to raise capital for operations and expansion. Many minority and women owned and other small businesses are under capitalized. This lack of capital also impacts their ability to borrow from banks. Section 1244 of the Internal Revenue Code provides for an individual to take an ordinary tax deduction of up to $100,000 on a joint tax return or $50,000 on an individual return for stock purchased in a small business if that stock becomes worthless or is sold at a loss.

Section 1244 was written to provide tax relief to an investor in a small business presumably as an inducement to invest in a small business.

Statistically, many of small businesses fail within 5 years of formation. Thus, the provisions of Section 1244 are of great importance to the small business investor.

The major problem of Section 1244 is it creates an illusory incentive for the investment in small business The business must fail for the investor to take advantage of the deduction.

The Small Business Investment Incentive Act corrects the illusory aspects of Section 1244 by offering an immediate (up front) positive incentive.

If it is assumed the majority of small businesses fail, then the difference between the Small

Business Investment Incentive Act and Section 1244 is timing only.

On the other hand, if the business is successful and the investor receives all of his invested capital back, then the tax benefit received will be paid back to the Treasury under the recaptive provision of this Small Business Investment Incentive Act.

The Small Business Investment Incentive Act, over a period of time, will produce the exact effect of Section 1244. It creates a stronger inducement to provide needed capital for the small business community.

This Small Business Investment Incentive Act would permit a qualified small business to raise up to $500,000 for operations and expansion through sale of its stock while allowing individual investors a deduction up to $25,000 on their tax returns ($50,000 on joint return) for stock purchased in that small business. Qualified small businesses should include C and S corporations. In order to be sure that this provision is not turned into a tax shelter, there will be no repayment for five years. An investor can not receive salary, interest, rent, dividends, or any other payment from the small business for the five year period. This will keep it from being utilized as a tax shelter and also will limit the investments in the business to new investors. I strongly believe that the impact of such a provision would be to create a strong incentive for individuals to invest in good small businesses. Nobody is going to invest in a small business just in order to get the tax deduction. Once a corporation has more equity capital it can then leverage this by going to a bank and being able to properly finance its business. This provision will create a number of new jobs, and after all it is the jobs that

create the tax revenue and makes our economy grow. I believe that within a three year period this incentive act will provide net revenue and therefore will also act as a way of reducing the budget deficit. Small business is the economic engine that drives this country.

NORTH AMERICAN EQUIPMENT DEALERS ASSOCIATION
Serving Farm, Industrial and Outdoor Power Dealers

John J. Mullenholz, Legislative Director
(202) 296-8000

February 27, 1995

The Honorable Jan Meyers
Chairman, House Small Business Committee
2361 Rayburn Building
Washington, DC 20515

Dear Congresswoman Meyers:

I am writing on behalf of the over 5,500 U.S. members of the North American Equipment Dealers Association to urge your support of legislation to reduce the capital gains tax rates and to index capital gains for inflation.

NAEDA's members are the farm, industrial and outdoor power equipment dealers located throughout the nation. With an average of 17 employees per dealership, they are often among the largest employers in their communities.

As with every business, investment is critical to the success of a dealership. Raising capital is often more difficult in the smaller communities where most dealers are located--but it is difficult for small businesses anywhere. Today, capital gains tax rates create a disincentive to continue pouring human and financial capital into the dealership and other businesses. Indeed, the opposite should be the case--dealers and other small businesses should be encouraged to form, to grow, and to employ. The benefit NAEDA's dealers provide to their communities is not merely service to their customers, it is also stable employment at fair wages for over 90,000 Americans.

Encouraging investment in small business is good for America, and particularly for rural America. Before you is the opportunity to provide that encouragement by reducing the capital gains tax rate and indexing future gains for inflation. I urge your support.

Sincerely,

John J. Mullenholz

STATEMENT
on the
CAPITAL GAINS REFORMS
of the
JOB CREATION AND WAGE ENHANCEMENT ACT OF 1995
for submission to the
HOUSE COMMITTEE ON SMALL BUSINESS
for the
U.S. Chamber of Commerce
by
William T. Sinclaire
Senior Tax Counsel and Director of Tax Policy
February 8, 1995

The U.S. Chamber of Commerce, representing 215,000 corporations, 3,000 state and local chambers of commerce, and 1,200 trade and professional organizations, appreciates this opportunity to express its views on the Capital Gains Reforms (Title I) provisions of the *Job Creation and Wage Enhancement Act of 1995* (H.R. 9).

The Chamber has long advocated the need to reduce the tax on capital gains and fully supports the capital gains reforms proposals that would (1) exclude 50 percent of capital gains income, (2) index the basis of capital assets for inflation, and (3) allow individuals to deduct any capital loss with respect to the sale of a principal residence.

Generally, a taxpayer does not recognize gain or loss on an asset for income tax purposes until the asset is disposed of. Currently, a taxpayer's net capital gain for a tax year is taxed as ordinary income, subject to certain maximum tax rates. One's net capital gain is the excess of net long-term capital gain over net short-term capital loss for the tax year. Gain or loss is considered long-term when a deposed asset has been held for more than one year.

A capital asset is generally any property, except (a) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business, (b) depreciable or real property used in a taxpayer's trade or business, (c) specified literary, musical or artistic property, (d) business accounts or notes receivable,

or (e) certain U.S. publications. In addition, part or all of the net gain from the disposition of certain property used in a taxpayer's trade or business may be treated as long-term capital gain.

Before the enactment of the *Tax Reform Act of 1986* (TRA '86), individuals were entitled to deduct, as an adjustment from gross income, 60 percent of their net capital gain. This resulted in a maximum long-term capital gains tax rate of 20 percent (40 percent of capital gains included in income times a 50 percent overall maximum tax rate) for individuals. Corporations were taxed at a maximum rate of 28 percent on net capital gains.

TRA '86 eliminated the capital gains deduction for individuals and the 28 percent rate ceiling for corporations. Therefore, by virtue of TRA '86, as well as the rate changes contained in the *Omnibus Budget Reconciliation Act of 1993* (OBRA '93), net capital gains are now taxed as ordinary income, subject to a maximum tax rate of 28 percent for individuals and 35 percent for corporations. However, OBRA '93 provided a 50-percent exclusion for gains from the sales of certain small business stock acquired at original issue and held for more than five years.

Generally, capital losses are fully deductible (dollar for dollar) against capital gains. In addition, noncorporate taxpayers may offset up to $3,000 of ordinary income each year with capital losses in excess of capital gains. Corporate taxpayers, however, are not entitled to offset ordinary income with net capital losses. Before TRA '86, noncorporate taxpayers were required to use two dollars of long-term capital loss to offset one dollar of ordinary income. However, this requirement was eliminated by TRA '86.

Noncorporate taxpayers may generally carry forward excess capital losses indefinitely. However, at a taxpayer's election, excess capital losses relating to "section 1256 contracts" may be carried back three years. Corporations, on the other hand, may carry back all excess capital losses three years, but may only carry them forward five years.

Also under current law, no adjustment is allowed for inflation in computing gain or loss on the disposition of an asset. The amount taken into account for the computation of gain or loss is the sales price of the asset and the taxpayer's adjusted basis for the asset. A taxpayer's basis is generally his initial cost of the asset, plus additions, less adjustments for depreciation, depletion, and certain other amounts.

A loss on the sale or exchange of a taxpayer's principal residence is currently treated as a nondeductible personal loss. However, gain on the sale or exchange of a principal residence is includible in income and is subject to tax at a maximum rate of 28 percent, unless the rollover or the exclusion provisions of Internal Revenue Code section 1034 or 121 apply.

Nonetheless, taxpayers generally may claim deductions for certain losses sustained during a tax year that are not compensated for by insurance or otherwise. These losses are limited to those incurred (a) in a trade or business, (b) in any transaction entered into for profit, or (c) through catastrophic events or theft.

The capital gains reforms proposals contained in H.R. 9 would allow (1) all taxpayers to exclude 50 percent of their net capital gains from their gross incomes, (2) all taxpayers to index the bases of their capital assets to eliminate inflationary gains, and (3) individual taxpayers to treat losses from the sales or exchanges of principal residences as capital losses.

In addition, enactment of H.R. 9 would repeal the provision in OBRA '93 that provides for a 50-percent exclusion of capital gain on the sale of qualified small business stock, and would reinstate the requirement that noncorporate taxpayers use two dollars of long-term capital losses to offset one dollar of ordinary income. Furthermore, the provisions in H.R. 9 would be effective for sales or exchanges occurring after December 31, 1994.

One of the intents of H.R. 9 is to cut the rate on which capital gains are taxed by allowing taxpayers to deduct 50 percent of their net long-term capital gains from gross

income. The result would be capital gains tax rates of 7.5%, 14%, 15.5%, 18% and 19.8% for individuals and 7.5%, 12.5%, 17% and 17.5% for corporations, depending on a taxpayer's income tax bracket.

Passage of H.R. 9 would also eliminate from taxation gains for certain assets that have resulted from inflation. The inflation adjustment would be made to the adjusted basis of an asset and would be calculated by using the Gross Domestic Product deflators of the calendar quarters in which the asset was acquired and sold. Indexation would apply to inflation and sales of assets occurring after December 31, 1994, regardless of whether the asset was acquired by the taxpayer prior to that date. Assets whose basis would be eligible for this inflation adjustment would generally include corporate stock and tangible property that are capital assets or property used in a trade or business and are held by a taxpayer for more than one year.

H.R. 9 also provides that losses from the sale or exchange of a principal residence would be treated as a deductible capital loss rather than a nondeductible personal loss. This would allow taxpayers to treat the loss from the sale or exchange of a personal residence the same as they would treat a loss from any other capital asset.

The Chamber universally supports the capital gains reforms provisions in H.R. 9. The current capital gains tax rates for individuals and corporations not only discriminate against capital gains income, but discourage venture capital formation, impede job creation, and hinder this country's international competitiveness. Lower capital gains tax rates would stimulate capital investment, promote technological innovation, create additional employment opportunities and expand the overall economy. Furthermore, capital gains rate reductions have historically increased federal tax revenues since rate reductions spur additional capital transactions and increase the overall tax base.

Opponents of capital gains rate reform continually renew the myth that a rate reduction would only benefit the wealthy. However, according to Treasury Department estimates (*Statistics of Income Bulletin*, Fall 1994), over 55 percent of the individual

taxpayers reporting capital gains in 1993 had adjusted gross incomes of $50,000 or less, nearly 74 percent had adjusted gross incomes of $75,000 or less, and over 83 percent had adjusted gross incomes of $100,000 or less. In addition, it must be remembered that these income figures include the gains from capital transactions.

Perhaps the most unfair aspect of the current method of taxing capital gains is that much of the gain from the sale of a capital asset is often attributable to inflation. When capital gains are due entirely or in part to inflation, taxing the entire gain serves only to confiscate capital generated from past income -- income that has already been taxed at least once. The proposed reforms would eliminate this unfairness by indexing the cost of capital assets for inflation.

Unlike a normal investment, if a taxpayer sells his principal residence at a loss, that loss can never be deducted from income -- even if there is gain from a prior or subsequent sale or exchange of a principal residence. H.R. 9 would correct this anomaly by allowing the loss from a sale of a taxpayer's home to be deductible as a capital loss.

The Chamber believes that the capital gains reforms provisions in H.R. 9 would benefit all Americans and provide for a brighter economic future and fully supports all aspects of the proposal.

ISBN 0-16-047329-2